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The Scope of Federal Securities Law Liability for Corporate Transactions

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THE SCOPE OF FEDERAL SECURITIES LAW LIABILITY FOR CORPORATE TRANSACTIONS

by
Larry E. Ribstein*

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I. INTRODUCTION

One particular problem under the federal securities fraud statutes has been the issue of liability arising from corporate transactions—that is, transactions entered into by or affecting the corporation as an entity as distinguished from transactions in securities markets by individual investors. This problem has arisen because of the uncertainty under the current statutes as to whether corporate transactions should be governed by the federal securities statutes as well as the applicable state law. The argument in favor of leaving these transactions to state regulation is that traditionally this has been an area of state control and, at the same time, not a central concern of the federal laws as currently drafted. On the other hand, a strong argument can be made that protection of shareholders from corporate mismanagement fits squarely within the overall goal of the federal statutes to protect both investors and the securities markets, and is consistent with the general antifraud language of the statutes. As a result of these countervailing pressures many ambiguities plague the federal regulation of corporate transactions.

The uncertainties of the application of federal law to corporate transactions create practical problems for corporate managers. Even if they have painstakingly structured a transaction to conform to such state common law and statutory requirements as fiduciary duties, appraisal rights, and disclosure, managers still must determine whether the transaction is permissible under the federal securities laws, whether federal law requires disclosure, and whether making limited further disclosure would create a risk of liability for misrepresentation greater than the risk of liability for proceeding without disclosure. These uncertainties also have added greatly to the time spent in litigating corporate problems, and thereby have exacerbated the strain on federal court resources.

This Article attempts to resolve these problems by delimiting the extent

to which corporate insiders and the corporation should be held accountable under federal law for injuries to stockholders resulting from transactions entered into by the corporation.¹ In general, the intent of this Article is to develop an approach to the existing statutory and case law, rather than to build a system of federal corporation law from scratch. The Article focuses on liability under the general antifraud provisions of the federal statutes, particularly section 10(b) of the Securities Exchange Act of 1934,² rule 10b-5 promulgated thereunder,³ and the principal Supreme Court interpretations of the statutes, including *Santa Fe Industries, Inc. v. Green*,⁴ *Blue Chip Stamps v. Manor Drug Stores*,⁵ and *Superintendent of Insurance v. Bankers Life & Casualty Co.*⁶ The Article also discusses the equivalent sections of the Federal Securities Code⁷ recently adopted by the American Law Institute and awaiting consideration by Congress. Since the Code represents the greatest hope for substantial revision of the securities laws for some time to come, it deserves special attention here, even though it is uncertain whether, when, and in what form the Code will become law.

The format of the Article is first to identify the precise questions unresolved under current law with respect to general antifraud liability for corporate transactions, and then to develop a method of answering these questions by identifying the relevant statutory and policy considerations. Finally, a scheme for imposition of federal liability for corporate transactions is proposed. The scheme suggests three basic principles. First, "deception" in the context of corporate transactions should include misrepresentations, but not every failure to disclose. Secondly, once a mis-

1. Potentially damaging transactions include not only the major changes in corporate structure, such as mergers, sales of assets, or changes in capital structure, most of which require shareholder approval and attendant disclosure, but also more limited transactions such as corrupt payments, loans, securities issuances, and purchase and sale of corporate assets and securities.

2. 15 U.S.C. § 78j(b) (1976) [hereinafter cited as 1934 Act]. The section declares it unlawful

[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. 17 C.F.R. § 240.10b-5 (1979). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. 430 U.S. 462 (1977).

5. 421 U.S. 723 (1975).

6. 404 U.S. 6 (1971).

7. ALI FEDERAL SECURITIES CODE (Proposed Official Draft 1978). For a general discussion of the 1978 version, see Committee on Federal Regulation of Securities, *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345 (1978).

representation in connection with a corporate transaction is established, no further connection with a securities transaction should be required. Finally, with respect to the duty to disclose, purely internal corporate transactions should be distinguished from those affecting the securities market.

II. QUESTIONS POSED BY THE CURRENT LAW

The present uncertainty for corporate managers arises when some corporate transactions are governed solely by state substantive law, while, on the other hand, additional compliance with the federal securities laws is required. This confusion arises from several unresolved questions presented by recent federal court decisions, including whether the general federal antifraud statutes impose substantive duties in addition to disclosure obligations; the nature of the substantive federal duty, if any; the materiality and causation requirements applicable to corporate transaction cases; and how the "in connection with the purchase or sale" requirement of rule 10b-5 should be applied. The following section examines the foregoing issues in light of recent lower court decisions, the recent Supreme Court guidance in *Santa Fe Industries, Inc. v. Green*,⁸ and the effect of the proposed Federal Securities Code.⁹

A. Breach of Fiduciary Duty Versus Misrepresentation

(1) *Liability for Breach of Substantive Fiduciary Duty.* The most important question affecting federal liability for corporate mismanagement has been the extent to which such liability is based not only on the amount of information disclosed, but also on breach of a "substantive" duty not to engage in conduct harmful to the corporation. The answer to this question is important because it directly involves the problem of overlapping state and federal jurisdiction referred to in the Introduction. Corporations owe their existence to state law, and state law has traditionally governed their substantive regulation. Over this traditional regulatory framework federal law imposes a requirement of adequate disclosure to investors.

In at least one case, *Schoenbaum v. Firstbrook*,¹⁰ the court seemed to base liability upon the defendant directors' and controlling shareholders' damaging transactions with the corporation, as distinguished from any nondisclosure of them.¹¹ Defendant Aquitaine purchased substantial blocks of the corporation's stock at a favorable price. The court held that Aquitaine and the directors of Banff were "guilty of deceiving the stockholders of Banff,"¹² but did not explain precisely how the shareholders had been deceived, or how their deception was connected to any loss. The

8. 430 U.S. 462 (1977).

9. ALI FEDERAL SECURITIES CODE (Proposed Official Draft 1978).

10. 405 F.2d 215 (2d Cir.) (en banc), cert. denied, 395 U.S. 906 (1969).

11. See Folk, *Corporation Law Developments—1969*, 56 VA. L. REV. 755, 805-12 (1970); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporate Law*, 55 VA. L. REV. 1103 (1969); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1032-36 (1973).

12. 405 F.2d at 220.

court's apparent theory of liability was that Aquitaine abused its control position, rendering the minority helpless and making disclosure a particularly ineffective way of protecting shareholders.¹³ This explanation of *Schoenbaum*, however, was made uncertain by a later decision by the same court denying federal liability when there was a similar abuse of control when merger terms favored controlling shareholders, but full disclosure to the other shareholders had been made in the proxy statements.¹⁴

In several other cases it was unclear whether liability rested on misrepresentations or, as in *Schoenbaum*, on a duty not to engage in the transaction. Some of these cases involved a situation similar to *Schoenbaum* in which a transaction was executed by the majority-controlled board of directors, so that any failure to disclose facts to the minority shareholders, who had no say, was arguably irrelevant to the injury.¹⁵ Of course, as is discussed in section II.C., some degree of misrepresentation may still be the key element in these cases, with the courts simply relaxing the causation requirement¹⁶ by taking into account such factors as the effect of the exercise of appraisal rights, the deterrent effect of advance disclosure, and the possibility that the shareholders could block the transaction in state court.¹⁷ On the other hand, the courts could be changing the actual theory of liability from the inequality of information to the misuse of corporate position, rather than attenuating the necessary link between the breach of duty and the harm.

In another group of cases the courts imposed liability when shareholders had been injured by transactions that were accompanied by misrepresentations.¹⁸ The courts upheld separate causes of action for the misrepresentations and for the concealed conduct itself, but did not make it clear whether there would have been liability under *any* theory if there had been no misrepresentation.¹⁹

13. See I A. BROMBERG, SECURITIES LAW: FRAUD § 4.7(545) (1977); Folk, *supra* note 11, at 806-11; Comment, *supra* note 11, at 1119.

14. Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972); see Note, *supra* note 11, for a critique of this case.

15. See Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); Jacobs v. Hanson, 464 F. Supp. 777 (D. Del. 1979); Weber v. Bartle, 272 F. Supp. 201 (S.D.N.Y. 1967); Globus, Inc. v. Jaroff, 271 F. Supp. 378 (S.D.N.Y. 1967) (motion for summary judgment); Globus, Inc. v. Jaroff, 266 F. Supp. 524 (S.D.N.Y. 1967) (motion to dismiss); Laurenzano v. Einbender, 264 F. Supp. 356 (E.D.N.Y. 1966), *aff'd*, 448 F.2d 1 (2d Cir. 1971); Eagle v. Horvath, 241 F. Supp. 341 (S.D.N.Y. 1965).

16. See Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

17. See notes 80-94 *infra* and accompanying text.

18. Alabama Farm Bureau Mut. Cas. Ins. Co. v. American Fidelity Life Ins. Co., 606 F.2d 602 (5th Cir. 1979); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967).

19. In *Rekant* the court appeared to hold that the cause of action rested on the corporation's issuance of its securities for less than adequate consideration, but in discussing a separate cause of action based on filing of misleading reports, the court stated that this cause of action "overlaps" the rule 10b-5 claim. 425 F.2d at 882. In *Dasho* and *Schlick* insiders reaped profits in connection with mergers. Although the courts indicated that the actions

(2) *Nondisclosure Cases.* Nondisclosure cases present special problems of characterization because the basis of liability is partly the inadequacy of the information conveyed, thus resembling active misrepresentation cases, and partly the damaging transaction that triggers the disclosure duty, thus resembling the substantive duty cases.²⁰ Nondisclosure liability most clearly resembles liability for breach of fiduciary duty in those cases in which the damaging transaction was executed on the corporation's behalf by directors who had complete information, but who failed to disclose the full terms of the transaction to the shareholders. The theory of liability in such cases is, at least implicitly, the agency rule that when officers and directors, acting as agents, act adversely to their principal, the corporation, their knowledge will not be imputed to the corporation, thereby negating the element of "deception."²¹ Thus, the duty to disclose hinges on whether the directors may be said to have breached a duty, and hence acted adversely, to the corporation.

Some courts clearly have based federal liability at least in part on breach of a duty to disclose to the shareholders, even when all directors had knowledge of the wrongful act.²² In *Goldberg v. Meridor*,²³ however, a leading post-*Santa Fe* case, the opinion, reviewing only the sufficiency of the pleadings, was not clear as to whether the nondisclosure to shareholders of the unfavorable terms of an asset purchase was sufficient for liability. The court indicated plaintiff could amend his complaint to show that the cause of action was based on misleading press releases,²⁴ and on remand the district court noted that the complaint had been so amended.²⁵ The Second Circuit also stated, however, that "disclosure or at least the absence of misleading disclosure is required" to avoid federal liability.²⁶

based on the unfair exchange ratios were separate from those based on the misrepresentation, the approval of the mergers, and therefore of the exchange ratios, seemed to be a product of the misrepresentations. Thus, it would be difficult to separate the two causes of action. In *Alabama Farm Bureau Mut. Cas. Ins. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979), the court recognized a cause of action in connection with corporate purchases of stock that allegedly entrenched management by inflating the price of the stock, thereby discouraging takeovers. Although plaintiff alleged misrepresentations and nondisclosures in connection with the purchases, the court indicated that the inflation of the stock value might itself violate rule 10b-5.

20. See 6 L. LOSS, SECURITIES REGULATION 3602 (1969); Note, *Goldberg v. Meridor: The Second Circuit's Resurrection of Rule 10b-5 Liability for Breaches of Corporate Fiduciary Duties to Minority Shareholders*, 64 VA. L. REV. 765, 773-74 (1978).

21. See I A. BROMBERG, *supra* note 13, § 4.7(546); Jacobs, *How Santa Fe Affects 10b-5's Proscriptions Against Corporate Mismanagement*, 6 SEC. REG. L.J. 3, 11 (1978); Note, *Suits for Breach of Fiduciary Duty under Rule 10b-5 After Santa Fe Industries, Inc. v. Green*, 91 HARV. L. REV. 1874, 1883 (1978).

22. See *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968); *Seigal v. Merrick*, 422 F. Supp. 1213 (S.D.N.Y. 1976). *But see Seigal v. Merrick*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,887 (S.D.N.Y. 1979) (motion to dismiss granted).

23. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

24. 567 F.2d at 218; see Note, *supra* note 20, at 770.

25. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,630 (S.D.N.Y. 1979).

26. 567 F.2d at 221.

If it is assumed that there is no federal liability for some kinds of total nondisclosure, including the situation discussed above in which fully-informed directors enter into corporate transactions without disclosure to shareholders, there is a further question as to when, if at all, there will be federal liability for nondisclosure. This question will be discussed in sections IV.B. and IV.G.(2).

(3) *The Decision of the Supreme Court in Santa Fe Industries, Inc. v. Green.* In *Santa Fe Industries, Inc. v. Green* the United States Supreme Court denied a federal cause of action for the "squeeze-out" of minority shareholders in a "going private" transaction.²⁷ There were essentially two grounds for the decision. First, the Court held that the federal cause of action must fall within the scope of section 10(b), which is limited to "deceptive" and "manipulative" conduct.²⁸ There was no deception in this case, since there was admittedly full disclosure to the stockholders.²⁹ Moreover, the freeze-out did not qualify as unlawful manipulation, since "manipulative" was interpreted by the Court to refer only to the traditional forms of market rigging.³⁰ Secondly, the Court stated that federal liability should not, for various policy reasons, extend to a "breach of corporate fiduciary duty."³¹

Santa Fe did not succeed in resolving the "misrepresentation" versus "substantive duty" problem. The Court held that no federal liability exists when there is full disclosure; that is, a breach of a substantive duty under state common or statutory law would not suffice for federal liability. The *Santa Fe* holding, however, may be interpreted to apply only to the precise circumstances of a "going private" transaction, so that full disclosure would not "cure" a different breach of a substantive duty, such as manipulation of a merger exchange ratio.³²

Santa Fe offers little guidance as to whether a federal cause of action could be based on total nondisclosure to shareholders. In a footnote to the opinion³³ the Court arguably accepted the lower court decisions³⁴ upholding federal liability in cases involving total nondisclosure to shareholders.

27. 430 U.S. 462 (1977).

28. *Id.* at 471-74.

29. *Id.* at 474.

30. *Id.* at 476. The only specific reference to § 10 in the Senate Report on the 1934 Act states merely that the section was "aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. REP. No. 792, 73d Cong., 2d Sess. 6 (1934).

31. 430 U.S. at 477-80. The court particularly emphasized that the extension of federal liability to breach of corporate fiduciary duty would bring a wide variety of corporate conduct traditionally reserved to state regulation within the ambit of the rule. *Id.* at 478.

32. See Jacobs, *supra* note 21, at 20.

33. 430 U.S. at 475 n.15.

34. See *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972); *Shell v. Hensley*, 430 F.2d 819 (5th Cir. 1970); *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968).

Santa Fe has been so interpreted in subsequent cases and commentary.³⁵ On the other hand, Justice White states clearly in the last section of the opinion that there should be no federal liability for substantive mismanagement.³⁶ This suggests that federal liability may not be based, as it is in the cases discussed in the previous section, on breach of substantive duty accompanied by nondisclosure.³⁷

(4) *The Federal Securities Code*. In light of the persistent controversy centered upon the issue of disclosure—substantive duty, the codification offered in the proposed Federal Securities Code is a possible source of resolution. On the surface, however, the Federal Securities Code seems to leave the law as it stands under a broad reading of *Santa Fe*: Federal liability may be based on nondisclosed breach of substantive duty, but may not be based on breach of fiduciary duty when there has been full disclosure.

With respect to nondisclosure liability, section 1602 is analogous to rule 10b-5 and section 17(a) in its treatment of general antifraud liability for corporate transactions. Section 1602 declares it "unlawful . . . to engage in a fraudulent act . . . in connection with . . . a sale or purchase of a security."³⁸ "Fraudulent act" is defined in section 262 to include "an act . . . that (1) is fraudulent or (2) operates or would operate as a fraud."³⁹ Standing alone, this language could be held to extend beyond misleading disclosures to include nondisclosure of substantive misfeasance as well. This interpretation is supported by section 262(e), "[t]he existence of a fraudulent act is not precluded by the fact that it constitutes company mismanagement,"⁴⁰ and by section 262(b), which includes nondisclosure in its definition of "fraudulent act." The comments in note 2(y) to section 1603 interpret section 262(e) to be consistent with the interpretations of *Schoenbaum* and *Santa Fe* that federal liability may be based on nondis-

35. See *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978); Block & Schwartzfeld, *Corporate Mismanagement and Breach of Fiduciary Duty after Santa Fe Industries, Inc. v. Green*, 2 CORP. L. REV. 91, 100-01 (1978); Jacobs, *supra* note 21, at 12-13; Sherrard, *Federal Judicial and Regulatory Responses to Santa Fe Industries, Inc. v. Green*, 35 WASH. & LEE L. REV. 695, 702-03 (1978); Note, *supra* note 21, at 1881-84. But see Campbell, *Santa Fe Industries, Inc. v. Green: An Analysis Two Years Later*, 30 MAINE L. REV. 187, 192 (1979) (arguing that this interpretation is a "defection" from the rationale of *Santa Fe*); Note, *supra* note 20, at 775-77 (arguing that the result is inconsistent with Part IV of *Santa Fe*).

36. 430 U.S. at 477-80.

37. See text accompanying notes 20-26 *supra*. This interpretation would apparently be inconsistent with the court's earlier expansive view of the federal mismanagement cause of action expressed in *Bankers Life*. As will be discussed in section IV.B. of this Article, however, that case arguably involved conduct comparable to misrepresentation. See note 198 *infra*. Thus, the holding of *Bankers Life* would not be consistent with a narrow interpretation of *Santa Fe*.

38. ALI FEDERAL SECURITIES CODE § 1602(a) (Proposed Official Draft 1978).

39. *Id.* § 262(a).

40. *Id.* § 262(e).

closed mismanagement.⁴¹ Note 3(b) to section 1603 also cites cases imposing fraud liability for "nonverbal acts," as well as for breach of trust in equitable cases, and even recognizes the possibility that fraud may include "gross unfairness."⁴²

Two other sections specifically recognize liability when self-dealing of officers and directors approve damaging corporate transactions while in possession of all the facts. Section 287(b) provides: "The fact that any or all of the directors and officers of a company plaintiff are defendants with knowledge of a fact does not of itself establish the company's knowledge of the fact."⁴³ The effect of this provision is that the self-dealing director is excluded from the defense to fraud liability in section 1703(e) that is otherwise available when the plaintiff enters into a transaction with knowledge of the relevant facts.⁴⁴ Section 1709 provides for civil liability by a director (or other agent or fiduciary) to *his company* (or other "beneficiary") for damages caused by any of the director's transactions in violation of section 1602. This section recognizes a possible cause of action for fraud consisting of acts other than misleading the plaintiff, since the transaction that triggers liability need not be with the plaintiff.⁴⁵

Just as the Code seems to adopt that aspect of *Santa Fe* that permits liability for nondisclosed mismanagement, so it also seems to adopt the *Santa Fe* holding that disclosed mismanagement may not be the basis of federal liability. That is the position taken in note 1(b) to section 262 and note 3(b) to section 1603.

Despite the foregoing, whatever the drafters of the Code intended to accomplish, the Code's present language does not really change the present confused state of the law. Neither the language of the Code nor the comments preclude interpretations that provide broader or narrower grounds of federal liability than those outlined above. Although sections 262(e), 287(b), and 1709(a) all recognize the possibility of liability for nondisclosed mismanagement, they do not compel a court to recognize such liability. Rather, these sections merely provide that the inclusion of mismanagement in plaintiff's allegations does not, in itself, prevent a court from imposing liability. Thus, a court could hold, consistently with section 262, that a failure to disclose facts to the shareholders, coupled with a breach of fiduciary duty by the directors, is *not* sufficient to constitute a "fraudulent act."⁴⁶ A substantial argument against such a result is that it

41. *Id.* § 1603, Note, at 534.

42. The reporter cites, e.g., *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972); *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). See generally Note, *supra* note 11.

43. ALI FEDERAL SECURITIES CODE § 287(b) (Proposed Official Draft 1978).

44. A question arose in the debates in the American Law Institute as to whether the provision went beyond the self-dealing agent situation. The reporter, Professor Loss, took the position that it did not. 55 ALI PROCEEDINGS 435-38 (1978).

45. See ALI FEDERAL SECURITIES CODE § 1709, Note 5, at 583 (Proposed Official Draft 1978).

46. This contention was made by Professor Fiflis, 50 ALI PROCEEDINGS 426-27 (1973).

would render irrelevant the defense to fraud liability based on plaintiff's knowledge contained in section 1703(e) and the nonimputation of knowledge under section 287(b). Nevertheless, if post-*Santa Fe* cases ultimately reject liability for nondisclosed mismanagement, it is significant that such holdings could be continued under the Code.

It is even clearer that the Code does not prevent *broader* liability for mismanagement than is indicated above. Section 262(a) states only what a "fraudulent act" includes, and excludes nothing. Although note 1(b) to section 262 and note 3(b) to section 1603 explain that these sections do not overrule *Santa Fe*, this does not mean that overruling *Santa Fe* would necessarily be inconsistent with these actions. In fact, the use of the word "fraudulent" instead of the arguably more narrow "deceptive" encourages an overruling of the *Santa Fe* holding that there can be no liability where there is full disclosure. It is noteworthy that "deceptive" was used in the 1973 draft,⁴⁷ but was changed after some debate because the drafters believed that "fraudulent" would more clearly include fraud in the equitable sense of breach of fiduciary relationship.⁴⁸ The change was accompanied by an expanded note 3(b) to the final draft, which not only explains that "nonverbal acts" are covered, as provided in the original draft,⁴⁹ but adds the following interpretation:

And it may be assumed that there is a grey area in which "unfairness" if gross enough may merge into "fraud". But "fraud" still requires something more than "unfairness" or breach of fiduciary duty, . . . except perhaps in equitable actions, as to which the Supreme Court has reiterated: "Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another."⁵⁰

Thus, the present version of the Code has taken very nearly no position on the deception-mismanagement issue. It arguably provides for some liability for nondisclosed mismanagement, but it certainly does not foreclose liability for pure breach of fiduciary duty. This is consistent with the intention expressed by the American Law Institute not to draw the line between federal fraud liability and the state mismanagement area.⁵¹ Therefore, if the Code is adopted in its present version, even those few issues seemingly closed by *Santa Fe* could be reopened.

B. *What Is the "Substantive" Federal Duty?*

The previous section established that at least some federal courts have imposed liability for breach of fiduciary duty in connection with corporate

47. ALI FEDERAL SECURITIES CODE § 225 (Tent. Draft No. 2, 1973).

48. 50 ALI PROCEEDINGS 432-33 (1973).

49. ALI FEDERAL SECURITIES CODE § 225, Comment 2 (Tent. Draft No. 2, 1973).

50. ALI FEDERAL SECURITIES CODE § 1603, Note 3(b) (Proposed Official Draft 1978) (citations omitted).

51. The motion to "draw the line" between mismanagement and securities fraud was defeated "overwhelmingly." 50 ALI PROCEEDINGS 430 (1973).

transactions.⁵² In some of these cases, liability was based directly on breach of a substantive duty, while in others the liability was based on a duty to disclose that was triggered by a breach of a fiduciary duty. Assuming that imposition of federal liability on these grounds is proper, there is a further question as to what duties should serve as the basis of federal liability. This question is discussed separately for cases involving fiduciary duty and for cases involving nondisclosure.

(1) *Breach of Fiduciary Duty Alone.* As was discussed in section II.A.(1), the clearest case for federal liability for breach of fiduciary duty, if there is one, is a transaction that has been pushed through by a majority shareholder so that disclosure will not be helpful to the minority shareholders. Existing decisions fail to address a number of questions. Presumably, federal liability will not lie in every majority-control situation, but only when the transaction is, in some way, unfair.⁵³ What does unfair mean? Is it enough to sustain the transaction that there was an adequate business purpose? That the shareholders have some appraisal remedy? That the shareholders have an *adequate* appraisal remedy?⁵⁴

Apart from determining the ground rules of the *Schoenbaum* "controlling influence" cause of action, there is the additional question of whether this should be the *only* theory justifying a federal action based on breach of fiduciary duties. Besides oppression by majority shareholders, other situations call for more shareholder protection than disclosure provides, including those involving self-dealing by nonstockholding management in a management-controlled corporation, and negligence by managers in failing to detect activities harmful to the company.⁵⁵ Should there be federal liability in all or any of these cases?

(2) *Breach of Duty to Disclose.* As was discussed in section II.A.(2), the nondisclosure cases most clearly involving liability solely for breach of fiduciary duty are those in which the knowledge of directors was not imputed to the corporation because the directors had breached a duty to the corporation. The cases are in a state of confusion as to the circumstances that give rise to liability under this theory.

The common law agency rule of nonimputation of knowledge requires that the interests of the agent be wholly adverse from those of the principal.⁵⁶ The federal cases have required something less than total adversity, but how much less is not clear. Federal liability has been imposed when directors had approved transactions from which they stood to gain a direct

52. See text accompanying notes 10-19 *supra*.

53. See Folk, *supra* note 11, at 808-09.

54. See Dyer, *An Essay on Federalism in Private Actions under Rule 10b-5*, 1976 UTAH L. REV. 7, 16-22, for a discussion of these various standards.

55. See Kaplan v. Bennett, 465 F. Supp. 555 (S.D.N.Y. 1979) (denying federal liability for negligent mismanagement).

56. RESTATEMENT (SECOND) OF AGENCY § 282, Comments b & c (1957); W. SEAVEY, HANDBOOK OF THE LAW OF AGENCY 185-86 (1964).

economic benefit.⁵⁷ Cases of direct economic benefit, however, are often difficult to identify. For example, in *Kidwell ex rel. Penfold v. Meikle*⁵⁸ the court imposed liability upon directors who had an interest in a company that stood to gain from a transaction, but not upon directors whose only gain was the reduced risk to their personal guarantees resulting from the transaction. In *Maldonado v. Flynn*⁵⁹ the court held the following facts insufficient to impose federal liability, and hence indicated no breach of a federal substantive duty: one voting director could have lost legal fees from the corporation at the will of one of the benefitting but abstaining directors, and another voting director depended upon an abstaining director to cover up his illegal insider trading.

The federal cases have also recognized a duty to disclose when the directors who approved the transaction were not actually engaged in self-dealing, but were controlled by the beneficiary of the transaction, and so may be said to have acted to keep their jobs. The leading case for this theory is *Schoenbaum*, in which a federal liability was recognized when a transaction benefitting a controlling shareholder was approved by directors who were unaffiliated with the shareholder.⁶⁰ This theory may or may not extend to cases in which the voting directors were under the control of management directors who did not control through stock ownership. Some pre-*Santa Fe* cases recognizing a disclosure duty may have involved this situation,⁶¹ but the Second Circuit Court of Appeals held against such a duty in *Maldonado*,⁶² a post-*Santa Fe* case.

Authority is split with respect to whether there is a breach of duty when the voting directors acted to keep their jobs by buying out dissident shareholders. The pre-*Santa Fe* cases tended to recognize breach of a federal duty in this situation,⁶³ but post-*Santa Fe* cases have denied liability.⁶⁴

57. *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); *Hoff v. Sprayregen*, 339 F. Supp. 369 (S.D.N.Y. 1971).

58. 597 F.2d 1273 (9th Cir. 1979).

59. 597 F.2d 789 (2d Cir. 1979).

60. See *Folk*, *supra* note 11, at 811-12.

61. *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970); *Condon v. Richardson*, 411 F.2d 489 (7th Cir. 1969); *Hoff v. Sprayregen*, 339 F. Supp. 369 (S.D.N.Y. 1971). In *Hoff* and *Condon* liability may have been based on misrepresentations or nondisclosures to the board of directors. See text accompanying notes 198, 202-05 *infra*.

62. 597 F.2d 789 (2d Cir. 1979).

63. See *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); *Seigal v. Merrick*, 422 F. Supp. 1213 (S.D.N.Y. 1976), *objection to settlement sustained*, 441 F. Supp. 597 (S.D.N.Y. 1977), *appeal dismissed*, 590 F.2d 35 (2d Cir. 1978); *Weber v. Bartle*, 272 F. Supp. 201 (S.D.N.Y. 1967) (concealment from a minority of the board that the purpose of a tender offer was to maintain control held actionable). But see *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964). The denial of liability in *O'Neill* has been explained as a refusal to impose liability upon defendants whose motive was keeping their jobs rather than self-enrichment or other selfish purpose. See 6 L. Loss, *supra* note 20, at 3631-45 (1969); Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self Aggrandizement*, 15 N.Y.L.F. 332, 337-44, 351-58 (1969); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146, 1164-66 (1965).

64. See *Seigal v. Merrick*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,887 (S.D.N.Y. 1979); *Tyco Laboratories, Inc. v. Kimball*, 444 F. Supp. 292 (E.D. Pa. 1977);

All of the above cases involve impairment of the directors' judgment by some kind of self-interest. Given the denial of liability even in some of these cases, it is not surprising that a court also denied liability in a recent case involving overseas payments, when there was nothing more than "negligent abdication . . . of duties."⁶⁵

Some cases have recognized nondisclosure liability even when no stockholders were injured at the time of the fraud. In some of these cases⁶⁶ it is unclear whether the court is protecting future stockholders or present creditors. In *Pettit v. American Stock Exchange*⁶⁷ the court made it clear that the basis of liability was the existence of a scheme to defraud later public shareholders. In *International Controls Corp. v. Vesco*⁶⁸ the court recognized section 10(b) liability in connection with the spinoff of an asset to shareholders, thus explicitly protecting the rights of the corporation's creditors. The court relied on *Superintendent of Insurance v. Bankers' Life & Casualty Co.*,⁶⁹ in which the Supreme Court held, in effect, that the seller of all of the stock of a corporation has a duty of reasonable care toward policy holders and other creditors to ensure that the stock purchaser does not loot the company. Other courts have questioned whether the securities laws should protect corporate creditors and nonshareholders.⁷⁰

The *Meikle* case⁷¹ raises the question of whether there is a duty to disclose transactions about which all of the directors were informed *and* some were disinterested. The question was not discussed in *Meikle*, but the court implicitly recognized a federal duty by imposing liability on the interested directors.⁷²

Finally, a question related to that dealt with in the foregoing cases is the appropriate relief that should be given, assuming the court finds that the directors have breached a substantive federal duty. Should the court unwind the transaction, to the possible detriment of a third party? In *Schoenbaum*, if a trial on remand established a violation, the court could have ordered the Aquitaine transaction unwound because Aquitaine was a "controlling influence."⁷³ It is not clear whether only majority shareholders qualify as a controlling influence, and whether third parties, who are not included, may nevertheless lose the benefit of the transaction. Further, if the transaction is not unwound, under what circumstances may the directors be held liable for damages?

Falkenberg v. Baldwin, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,086 (S.D.N.Y. 1977); Block & Schwartzfeld, *supra* note 35, at 103.

65. Kaplan v. Bennett, 465 F. Supp. 555 (S.D.N.Y. 1979).

66. Miller v. San Sebastian Gold Mines, Inc., 540 F.2d 807 (5th Cir. 1976); Bailes v. Colonial Press, Inc., 444 F.2d 1241 (5th Cir. 1971).

67. 217 F. Supp. 21 (S.D.N.Y. 1963).

68. 490 F.2d 1334 (2d Cir. 1974).

69. 404 U.S. 6 (1971).

70. Superintendent of Ins. v. Freedman, 443 F. Supp. 628, 639 (S.D.N.Y. 1977); Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1101 n.16 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971).

71. Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979).

72. *Id.* at 1297.

73. 405 F.2d 215, 219-20 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

The duty-to-disclose cases present a hodgepodge of distinctions between the situations in which a duty will be imposed and those in which it will not. Since the basic question is whether the directors' knowledge is to be imputed to the corporation, consistency with this theory would require distinctions according to how substantially the directors' judgment has been impaired by self-interest. Instead, the courts have distinguished between directors who are acting under a "direct" economic incentive, and those who are acting under other incentives, such as keeping their jobs, even though the impairment of judgment is similar in both cases.⁷⁴ Even more irrational is the tendency to distinguish between situations in which directors are acting to keep their jobs. Although the courts have favored liability in the "controlling influence" cases, in fact, such cases are the weakest cases for a disclosure duty since, by their very nature, any disclosure to the shareholders will have the least practical effect on preventing the transactions. The controlling-influence situation should be singled out for liability only if the courts explicitly recognize that liability is being based upon a breach of substantive duty that has the *effect* of deception by rendering impotent the shareholders' vote, or if the case involves the issue of giving relief that affects a third party to the transaction.⁷⁵

The holding in *Meikle* that disclosure to the shareholders is required even when some directors are disinterested may also be inconsistent with the impaired judgment theory. In such a case the knowledge of the disinterested directors could be imputed to the corporation, so that any liability would have to be based on breach of substantive duty alone rather than on nondisclosure.⁷⁶

Even if all of the federal cases concerning the scope of the federal disclosure duty could be reconciled, the more fundamental question remains: When *should* a federal disclosure duty be imposed? In other words, which director decisions create liability under federal law in the absence of disclosure? There is no apparent reason why the agency nonimputation theory should be the exclusive basis of the federal duty. Why not require disclosure of *all* director decisions? Of all "major" decisions? Finally, why distinguish the duty to creditors from the duty to shareholders? The sheer number of these questions concerning the federal substantive duty is enough to counsel caution in imposing federal liability in such cases, as will be discussed in section II.A.(2). below.

(3) *Santa Fe and the Federal Securities Code.* Neither *Santa Fe* nor the Federal Securities Code provide definite answers to the foregoing

74. See Sherrard, *supra* note 35, at 708-10 for a similar criticism of this distinction. But see *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964) (denying recovery under state law in this situation).

75. See text accompanying note 72 *supra*.

76. See Sherrard, *supra* note 35, at 710. It could be argued that the knowledge of the disinterested minority directors is irrelevant because they are powerless to do anything with the information. This argument, however, would be inconsistent with the assumption in the cases imposing liability in majority-control situations that disclosure could have prevented the transaction. See text accompanying notes 80-94 *infra*.

questions. *Santa Fe* cites with apparent approval the duty-to-disclose cases,⁷⁷ but the Supreme Court did not comment on the specific theory of these cases. Although the Federal Securities Code recognizes the nonimputation theory,⁷⁸ it is only in connection with defenses, and even then it only permits use of it rather than expressly endorsing it.

C. *Extent of Liability for Misrepresentations*

To the extent that the federal duty is one to provide information, what are the rules governing this duty? This question involves two separate inquiries: First, how material must the misrepresentation be to create liability? Secondly, what causal nexus must there be between the misrepresentation and the harm?

Materiality tests the seriousness of the misrepresentation, or the amount of information that must be concealed or distorted to incur federal liability. There have been various attempts to define a general materiality standard,⁷⁹ but little attention has been paid to the special problems of applying any such standard in the context of corporate transactions. The policies that weigh against federal liability in this area must be balanced against the special information needs of the ordinary shareholder who must vote on a complex transaction. This analysis will be undertaken in section IV.C.(1) below.

The causation problem is much more difficult. In the first place, losses caused to participants in the securities market by the transaction must be distinguished from those caused to shareholders. Causation of market losses is solely a matter of whether investors would have bought or sold but for the lack of disclosure, which is a function of the significance of the information omitted. This is materiality, or its first cousin reliance, which will be discussed in section IV.C.(1). The more interesting problem is whether the misrepresentation has hurt the corporation as a whole, and thereby shareholders who retained their stock. With respect to this question, it is necessary to delve into the mysteries of the control of the public corporation and of shareholder-derivative suits.

The most straightforward situation to illustrate the required causation is one in which disinterested shareholders or directors vote on a transaction after receiving allegedly inadequate information. If the misrepresentation or nondisclosure is material, it clearly caused the injury resulting from the transaction. In three other typical situations causation is not so clear: first, when the decision is presented to the shareholders, but the defendant directors or majority shareholders control sufficient votes to approve the transaction regardless of the votes of the deceived shareholders;⁸⁰ sec-

77. 430 U.S. at 475 n.15.

78. See section II.A.(4) *supra*.

79. See, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

80. *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Jacobs v. Hanson*, 464 F. Supp. 777 (D. Del. 1979); *Globus, Inc. v. Jaroff*, 271 F. Supp. 378 (S.D.N.Y. 1967) (motion for summary judgment); *Globus, Inc. v. Jaroff*, 266 F. Supp. 524 (S.D.N.Y. 1967) (motion to dismiss); *Laurenzano v. Einbender*, 264 F.

only, when the decision is not presented to the shareholders, but the facts have been fully disclosed to an interested board of directors;⁸¹ and, thirdly, when the transaction is decided by a board of directors, a minority of whom are disinterested but not fully informed.⁸²

In the first situation the causation element may be satisfied if full disclosure could have upset the transaction through mass exercise of appraisal rights. Causation of damage directly to individual shareholders must be distinguished here from causation of damage to the corporation. A shareholder who has been misled into giving up appraisal rights may have an individual action for the damage resulting from such a loss, but no derivative suit will lie unless the corporation has been injured.⁸³ Loss of appraisal rights may be said to have damaged the corporation when there is a real possibility that disclosure would have caused exercise of appraisal rights on such a scale that the damaging transaction would not have been feasible,⁸⁴ and hence would have been abandoned.

In all three situations the misrepresentation could be said to have caused the transaction if full disclosure would have led to a shareholders' derivative action under state law.⁸⁵ This theory of loss causation through preclusion of a state remedy is very difficult to apply, since the court must determine both whether a state remedy exists and whether that remedy once was available to the plaintiff but has since been precluded because of inadequate disclosure. With respect to the second question, at the time of the federal action must the statute of limitations on a damage remedy have run, or, if it has not run, must damages under state law have been an inadequate remedy?⁸⁶ With respect to the existence of a state remedy, is it sufficient that a state remedy might have been alleged, or must it also have withstood dismissal? The courts are split on this question, although few returns are in.⁸⁷ A test requiring that the state action would have been

Supp. 356 (E.D.N.Y. 1966), *aff'd*, 448 F.2d 1 (2d Cir. 1971); *Eagle v. Horvath*, 241 F. Supp. 343 (S.D.N.Y. 1965).

81. See cases cited at note 22 *supra*.

82. See cases cited at note 198 *infra*.

83. See, e.g., DEL. CODE ANN. tit. 8, § 327 (Rev. 1974); TEX. BUS. CORP. ACT ANN. art. 5.14 (Vernon Supp. 1980).

84. See *Cole v. Schenley Indus., Inc.*, 563 F.2d 35 (2d Cir. 1977); *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1969); *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228 (D. Del. 1978).

85. For discussions of this type of causation, see *Alabama Farm Bureau Mut. Cas. Ins. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979); *Selk v. St. Paul Ammonia Prods., Inc.*, 597 F.2d 635 (8th Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209, 218-19 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Wright v. Heizer Corp.*, 560 F.2d 236, 250 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); *Klamberg v. Roth*, 473 F. Supp. 544 (S.D.N.Y. 1979); *Jacobs v. Hanson*, 464 F. Supp. 777 (D. Del. 1979); *Evmar Oil Corp. v. Getty Oil Co.*, [1978-1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,358 (C.D. Cal. 1978); Note, *supra* note 21, at 1889-98.

86. See Note, *Rule 10b-5 Corporate Mismanagement Cases: Who Must Deceive Whom?*, 63 NW. U.L. REV. 477, 486-87 (1968).

87. See *Alabama Farm Bureau Mut. Ins. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979). Compare *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978), and *Goldberg v. Meridor*, 426 F. Supp. 1059 (S.D.N.Y. 1977) (allowing federal liability if action would have withstood dismissal in a state court), *with*

successful has the advantage of ensuring that the nondisclosure in fact caused the transaction, and so is the true basis of liability. Such a requirement, however, has the disadvantage of forcing the federal courts to decide a matter of state substantive law.⁸⁸ Whichever of these tests is decided upon, the substantial problem of proving what a state court would have held remains.⁸⁹

Another attempt to satisfy the causation requirement in these situations is to replace proof of causation with a presumption that the transaction would have been deterred or upset by market reaction to the disclosure, had it been required. This approach apparently has been accepted by some courts⁹⁰ and commentators.⁹¹ It has appeared in the form of a holding that the causation requirement under section 10(b) is less than that under section 14(a).⁹² While this relaxed standard of causation under section 10(b) has the virtue of deterring misrepresentations, important policies may be compromised by permitting liability for misleading statements without requiring the misleading statements to have actually caused the harm.

The third causation situation involves a disinterested but not fully informed minority on the board of directors. It is arguably similar to the first two situations, since even full disclosure could not have prevented the decision to engage in the harmful transaction. On the other hand, in the third situation part of the decision-making body itself is uninformed. It is possible that the uninformed directors could have caused a change in the vote through persuasion of other directors. Moreover, even if the directors' vote would have been the same, a director may be presumed to have more incentive and resources to fight the transaction in the courts or

Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978), and *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979) (allowing federal liability only if state action would have succeeded). For a discussion of appropriate standards to apply with respect to those questions, see Note, *supra* note 21, at 1893-98.

88. See *Alabama Farm Bureau Mut. Cas. Ins. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979); Note, *supra* note 21, at 1889.

89. A good example of how this might be a problem is presented by *Santa Fe* itself. The Court seems to recognize the state remedies causation theory, but states there would have been no state remedy under the circumstances before it. See note 93 *infra*. This is no longer necessarily true after *Singer v. Magnavox Co.*, 367 A.2d 1349 (Del. Ch. 1976). See Note, *supra* note 21, at 1891.

90. *Jones v. National Distillers & Chem. Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,140 (S.D.N.Y. 1979); see *Healey v. Catalyst Recovery of Pa., Inc.*, 463 F. Supp. 740, 744 (W.D. Pa. 1979); *Weber v. Bartle*, 272 F. Supp. 201 (S.D.N.Y. 1967); *Laurenzano v. Einbender*, 264 F. Supp. 356 (E.D.N.Y. 1966), *aff'd*, 448 F.2d 1 (2d Cir. 1971).

91. See 1 A. BROMBERG, *supra* note 13, § 4.7(556); Bloomenthal, *supra* note 63, at 377.

92. See *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975). The Second Circuit described a two-part test for causation for § 14(a) proxy violations: "[T]here would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violations in question caused the appellant to engage in the transaction in question." 507 F.2d at 380 (emphasis in original; footnote omitted). With respect to a § 10(b) violation involving market manipulation in connection with a merger, however, the court held that the plaintiff need only prove that the nondisclosed manipulation caused economic loss in the form of an unfair exchange ratio, and not that the nondisclosure itself caused the merger. *Id.* at 381.

through other means than ordinary shareholders. For all of these reasons, perhaps there should be a greater readiness to find causation in the third situation than in the other two. The cases have not, however, discussed this issue.

Thus, existing cases make uncertain exactly what causative connection should be required between the breach of duty and the harm. As was true of the nature of the substantive federal duty, neither the Federal Securities Code nor *Santa Fe* takes a position with respect to materiality and causation in the mismanagement context. The *Santa Fe* opinion seems to recognize the preclusion of the state remedy theory, but takes no precise position.⁹³ The Federal Securities Code has general tests for causation and materiality, but, insofar as the mismanagement cases are concerned, it does no more than leave open the issue of "nonnumerical" causation.⁹⁴

D. *The "In Connection With" Requirement: The Role of the Securities Transaction*

(1) *The Case Law.* Section 10(b) prohibits the use or employment of manipulative or deceptive devices "in connection with the purchase or sale of any security." This "in connection with" requirement, as applied by the courts, raises two separate sets of problems. First is the question of who has standing to sue. The Supreme Court held in *Blue Chip Stamps v. Manor Drug Stores* that a plaintiff must have been a purchaser or seller of securities.⁹⁵ Secondly, there is the separate question, dealt with in *Superintendent of Insurance v. Bankers Life*,⁹⁶ of whether the defendant's fraud is connected with the plaintiff's purchase or sale.

Under the purchaser-seller standing rule of *Blue Chip Stamps*, a court inquires whether the plaintiff has entered into the type of transaction that qualifies him for the protection of the securities laws. It has long been recognized that the purchase or sale requirement can be satisfied by transfers other than a standard market transaction, such as a pledge of securities⁹⁷ or a loan transaction.⁹⁸ It is also clear that standing may result from either a corporate securities transaction,⁹⁹ as to which stockholders may

93. 430 U.S. at 474 n.14; see Note, *supra* note 21, at 1886-89.

94. See ALI FEDERAL SECURITIES CODE § 215A, comment 4(a) (Tent. Draft No. 2, 1973).

95. 421 U.S. 723, 749 (1975).

96. 404 U.S. 6 (1971).

97. See *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970). But see the authorities discussed in *Mansbach*, 598 F.2d at 1029.

98. See *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970). But see *Reid v. Hughes*, 578 F.2d 634 (5th Cir. 1978); *Ross v. Longchamps, Inc.*, 336 F. Supp. 434 (E.D. Mo. 1971). There are also numerous cases dealing with promissory notes as securities outside of the context of corporate transactions. See *Exchange Nat'l Bank v. Touche, Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976); *C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir. 1975).

99. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971) (corporation's purchase or sale of portfolio securities); *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969) (corporation's issuance of shares in a merger); *Hooper v. Mountain States Sec. Corp.*, 282

bring a derivative suit, or a transaction by an individual stockholder.

Even these broad possibilities for standing, coupled with an expansive rule as to what constitutes a securities transaction, has nevertheless left anomalous gaps in protection. Thus, on the one hand, courts have recognized causes of action for damages resulting from a corporate insider's misuse of his position for profit in transactions involving purchases of stock for inadequate consideration,¹⁰⁰ pledges of securities by the corporation for the benefit of the insider,¹⁰¹ sales of securities to the corporation for an inflated price,¹⁰² asset transactions whereby payment was made by the corporation's promissory notes,¹⁰³ payment of an excessive finder's fee to the insider,¹⁰⁴ and ordinary looting that was covered up by a securities transaction.¹⁰⁵ Liability to stock purchasers injured by undisclosed misconduct has also been recognized in cases involving the purchase of underpriced corporate stock by an insider,¹⁰⁶ the rakeoff of royalties by the corporation's president,¹⁰⁷ and improper payments to retailers and violations of foreign tax laws.¹⁰⁸ The courts have even recognized a cause of action when the stockholder alleged a purchase connected with a misrepresentation or omission concerning an intention not to engage in mismanagement.¹⁰⁹

On the other hand, federal courts have denied a federal cause of action in cases involving quite similar types of abuse of insider position for profit when there was no securities transaction by either the individual shareholder or the corporation. These cases have involved looting,¹¹⁰ establishment of excessive employee bonuses for the benefit of insiders,¹¹¹ payment of an excessive commitment fee in a loan transaction,¹¹² usurping a corporate opportunity,¹¹³ sale of assets, even though payment was made by a

F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (corporation's issuance for money of its own securities); *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962) (corporation's repurchase of its own securities).

100. *Wolf v. Frank*, 477 F.2d 467 (5th Cir.), *cert. denied*, 414 U.S. 975 (1973); *SEC v. Fifth Ave. Coach Lines, Inc.*, 435 F.2d 510 (2d Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968); *Continental Bank & Trust Co. v. Garfinkle*, 292 F. Supp. 709 (S.D.N.Y. 1968).

101. *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970).

102. *Rekant v. Desser*, 425 F.2d 872 (5th Cir. 1970).

103. *Id.* at 878.

104. *Hoff v. Sprayregen*, 339 F. Supp. 369 (S.D.N.Y. 1971).

105. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

106. *Heilbrunn v. Hanover Equities Corp.*, 259 F. Supp. 936 (S.D.N.Y. 1966).

107. *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969).

108. *SEC v. Jos. Schlitz Brewing Co.*, 452 F. Supp. 824 (E.D. Wis. 1978) (SEC action based on injury to investors in the market).

109. *See cases cited in notes 252 & 253 infra.*

110. *SEC v. Fifth Ave. Coach Lines, Inc.*, 435 F.2d 510 (2d Cir. 1970); *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628 (S.D.N.Y. 1977).

111. *Lavin v. Data Sys. Analysts, Inc.*, 443 F. Supp. 104 (E.D. Pa. 1977).

112. *SEC v. Fifth Ave. Coach Lines, Inc.*, 435 F.2d 510 (2d Cir. 1970).

113. *Knauff v. Utah Constr. & Mining Co.*, 408 F.2d 958 (10th Cir.), *cert. denied*, 396 U.S. 831 (1969). *But see Kaplan, Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 918-19 (1976) (suggesting that there might be federal liability in this situation).

promissory note,¹¹⁴ and an extension of corporate credit for the benefit of an insider.¹¹⁵

A comparison of these cases shows that shareholders injured in very similar ways are treated differently under the federal securities laws.¹¹⁶ In fact, the cases would even support granting a cause of action to some shareholders and not to others, with respect to the same kind of corporate transaction.¹¹⁷ The cases suggest a need for an interpretation of the purchaser-seller rule that will lead to more equitable treatment of shareholders injured by mismanagement. The courts have been working toward such a result by recognizing liability in a growing number of cases in which the shareholder's purchase or sale of stock was constructive rather than actual. Thus, shareholders who have incurred losses through corporate action have been granted standing as "forced sellers" in cases involving short-form mergers¹¹⁸ or liquidations,¹¹⁹ and even in cases in which the shareholder has not actually been cashed out of the corporation, but the corporation has changed sufficiently that the plaintiff may be said to have "bought" different stock.¹²⁰

The courts have, however, retained some barriers to the federal cause of action. In the first place, they have refused to recognize standing when the shareholder has suffered a mere dilution of his interest because of the alleged mismanagement.¹²¹ A grey area lies somewhere between mere dilution and a radical change in the shareholder's interest. While the courts have identified a sufficient purchase-sale to constitute a section 10(b) cause of action by individual stockholders when control of the corporation has

114. *Ross v. Longchamps, Inc.*, 336 F. Supp. 434 (E.D. Mo. 1971).

115. *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970).

116. *Compare* *Ankant v. Desser*, 425 F.2d 872 (5th Cir. 1970) (liability upheld in asset sale involving promissory notes), *with* *Ross v. Longchamps, Inc.*, 336 F. Supp. 434, 439 (E.D. Mo. 1971) (denying federal cause of action for sale of assets involving promissory notes).

117. Compare the cases cited in notes 106-08 *supra* with the cases cited in notes 110-15 *supra*.

118. *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228 (D. Del. 1978).

119. *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976); *Dudley v. Southeastern Factor & Fin. Corp.*, 446 F.2d 303 (5th Cir. 1971); *Coffee v. Permian Corp.*, 434 F.2d 383 (5th Cir. 1970), *cert. denied*, 412 U.S. 920 (1973); *Jacobs v. Hanson*, 464 F. Supp. 777 (D. Del. 1979); *Garner v. Pearson*, 374 F. Supp. 591 (M.D. Fla. 1974).

120. *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515 (8th Cir. 1973); *Houlihan v. Anderson-Stokes, Inc.*, 434 F. Supp. 1330 (D.D.C. 1977); *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154 (S.D.N.Y. 1974); *Bogges v. Hogan*, 328 F. Supp. 1048 (N.D. Ill. 1971). See the discussion of cases cited in notes 118-20 *supra* in 1 A. BROMBERG, *supra* note 13, § 4.7(563); 5A A. JACOBS, *THE IMPACT OF RULE 10b-5*, § 117.02 (rev. ed. 1979).

121. *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187 (3d Cir. 1976); *Wolf v. Frank*, 477 F.2d 467 (5th Cir.), *cert. denied*, 414 U.S. 975 (1973); *Simmons v. Wolfson*, 428 F.2d 455 (6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971); *Cooper v. Garza*, 431 F.2d 578 (5th Cir. 1970); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Goodall v. Columbia Ventures, Inc.*, 374 F. Supp. 1324 (S.D.N.Y. 1974); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890 (D. Me. 1971). See discussion of these cases in 1 A. BROMBERG, *supra* note 13, § 4.7; 5 A. JACOBS, *supra* note 120, § 38.01(d); W. PAINTER, *THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE* § 6.04(a) (1979).

changed hands under a "substantial change" theory,¹²² or significant changes were made in a management contract,¹²³ they have denied federal relief when the corporation was reorganized,¹²⁴ changes were made in the controlling partnership agreement,¹²⁵ the corporation was put into bankruptcy,¹²⁶ or plaintiff lost working control of a corporation as a result of an agreement between two other shareholders.¹²⁷

Other than the substantial change theory of a constructive purchase-sale, the courts have not accepted theories that would further broaden the protected class of shareholders injured by mismanagement. In at least one case the court refused to analogize members of a nontrust business association to trust beneficiaries, who have been granted standing in other cases.¹²⁸ The courts have also rejected a "corporate veil" theory that would substitute the individual shareholders for the corporate entity and allow them to assert claims for injuries inflicted upon it by mismanagement.¹²⁹

The cases discussed above do not, in the end, solve the problem of the arbitrariness of the standing rule, since there has been no articulation of any standards or policies that would justify the distinctions being made. In the first place, the courts have not indicated what considerations should determine whether a transaction fits in the substantial change category. Why, for example, should some changes in shareholder rights serve as the basis for a federal cause of action, but not others? Are the controlling considerations the same as those that determine when shareholders get voting and appraisal rights under state law? Should they be the same? Moreover, the courts have not given any reasons why the substantial change theory should be the exclusive basis for finding a constructive purchase or sale. Why not accept, for example, the corporate veil theory?

Even if the problems surrounding the purchaser-seller requirement are solved, there is the additional problem of defining the requisite connection between the plaintiff's purchase or sale, whether actual or constructive, and the fraud. The necessary connection has become so attenuated in many cases as to suggest that, once having identified a securities transac-

122. *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515 (8th Cir. 1973); *Boggess v. Hogan*, 328 F. Supp. 1048 (N.D. Ill. 1971).

123. *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154 (S.D.N.Y. 1974).

124. *In re Penn Central Sec. Litigation*, 494 F.2d 528 (3d Cir. 1974).

125. *Abrahamson v. Fleschner*, 568 F.2d 862, 868 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

126. *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154, 1177-78 (S.D.N.Y. 1974).

127. *Canadian Javelin Ltd. v. Brooks*, 462 F. Supp. 190, 196-97 (S.D.N.Y. 1978).

128. *Compare Fox v. Prudent Resources Trust*, 382 F. Supp. 81, 88 (E.D. Pa. 1974) (denying standing to a limited partner), and *O'Brien v. Continental Illinois Nat'l Bank & Trust Co.*, 431 F. Supp. 292, 296 (N.D. Ill. 1977) (denying standing to trust beneficiary not a seller or purchaser), with *James v. Gerber Prod. Co.*, 483 F.2d 944, 948 (6th Cir. 1973), *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1093 (S.D.N.Y. 1977), *Klamberg v. Roth*, 425 F. Supp. 440, 443 (S.D.N.Y. 1976), and *Heyman v. Heyman*, 356 F. Supp. 958, 966 (S.D.N.Y. 1973) (all recognizing standing of trust beneficiaries). Cases of this type are discussed in 5 A. JACOBS, *supra* note 120 § 38.02(c).

129. *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 228 (8th Cir. 1970); *Gordon v. Lipoff*, 320 F. Supp. 905, 922 (W.D. Mo. 1970).

tion by the plaintiff, the courts will always find some connection. Thus, the courts have recognized a connection when the securities transaction was only a step in a larger fraudulent scheme,¹³⁰ or was otherwise only an incidental aspect of the fraud.¹³¹ One court went so far as to uphold a cause of action when there was only an unconsummated merger, on the theory that the fraud was aimed at the merger-to-be, and so was "in connection with" a securities transaction.¹³² It seems that satisfaction of the elements of section 10(b) is being achieved by dependence upon irrelevant details in order to uphold the federal cause of action. If the securities purchase or sale is necessary for a federal remedy, it should be required to be a central element of plaintiff's claim. If it is not necessary, the courts should not bother looking for it. The cases instead indicate that the courts have not made up their minds.

Thus, even with the more liberal "constructive purchase" and "connection" cases, confusing distinctions remain between the cases in which federal liability will and will not lie. There is a continuing need to identify a more rational basis for establishing or denying federal liability.

(2) *The Federal Securities Code.* The Code's treatment of the "in connection with" requirement not only fails to answer the questions raised in the preceding section, but also poses several new ones. To begin with, the Code preserves section 10(b)'s requirement of "in connection with a purchase or sale" of a security.¹³³ The Code comments mention the "anomaly . . . [of] the development of probably disparate standards and liabilities for corporate mismanagement depending on the presence or absence of a security transaction," but consider this anomaly to be a necessary evil in order to prevent the Code from becoming "a federal corporation law in the classic sense."¹³⁴ It is not clear, however, whether the Code's "in connection with" requirement is intended to expand or contract the coverage of current federal case law.

Unlike the existing general antifraud provisions, the Code defines unlawful conduct and provides for remedies in separate provisions. The Code's definition of unlawful conduct in section 1602(a) is much broader than sections 10(b) or 17(a), in that it expressly includes conduct "in connection with . . . an offer to sell or buy a security, or an inducement not to buy or sell a security." The notes explicitly state that this provision would

130. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971).

131. See *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d 259, 271 (3d Cir. 1978) (illegal payments happened to be part of a financing package in sale of businesses to foreign investors); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 594 (5th Cir. 1974) (misrepresentations that caused plaintiff to retain stock may have helped convince other stockholders to vote for merger); *Rekant v. Desser*, 425 F.2d 872, 882 (5th Cir. 1970) (corporate manager sold his property to corporation in return for securities exceeding the market value of the property); *Hoff v. Sprayregen*, 339 F. Supp. 369, 373 (S.D.N.Y. 1971) (illegal payment to managers made as finder's fee in connection with sale of stock).

132. *Herpich v. Wallace*, 430 F.2d 792, 810 (5th Cir. 1970).

133. ALI FEDERAL SECURITIES CODE § 1303 (Proposed Official Draft 1978).

134. ALI FEDERAL SECURITIES CODE § 1303, Comment 4, at 102 (Reporter's Revision of Text of Tentative Drafts Nos. 1-3, 1974).

continue to permit liability for conduct in connection with a potential purchase or sale¹³⁵ or for a misappropriation of corporate funds that incidentally involves a securities transaction.¹³⁶ The broad language of the statute would continue the existing applications of the "in connection with" rule outlined above.

Although the definition of unlawful conduct in section 1602(a) prohibits a range of corporate misconduct at least as broad as that reached under section 10(b), the civil remedies provided in part XVII of the Code limit the operation of section 1602(a) when relief other than an injunction is sought. Among the remedies provided in part XVII, those applicable to the corporate mismanagement cases include the general liability provision in section 1702, liability for breaches of fiduciary duty in section 1709, and the implied liability provision in section 1722. The general remedy provision, section 1702, provides for a cause of action only between buyers and sellers, applying only to nonmarket transactions.¹³⁷ This excludes the situation allowed under section 10(b) involving a plaintiff who is a purchaser or seller but who had no transaction with the defendant.¹³⁸

The Code provides a specific remedy for fiduciary situations in section 1709, which provides for a cause of action against a fiduciary for unlawful conduct committed by the fiduciary "in connection with effecting a purchase or sale of a security for the account or benefit of himself or a person or estate to whom he stands in a fiduciary relationship,"¹³⁹ even if the plaintiff is not a purchaser or a seller. Note 2 to this section justifies this apparent departure from *Blue Chip Stamps*¹⁴⁰ on the ground that the fiduciary relationship provides a sufficient nexus to satisfy the "philosophy" of that case. While this provision solves the problem of differentiating between cases on the basis of whether plaintiff could be considered a purchaser or seller, it creates the new problem of determining when the fiduciary could be considered to have engaged in a fraudulent act "in connection with effecting" a securities purchase or sale. It is not clear, for example, whether this would include situations resembling *Bankers Life*,¹⁴¹ in which the fraud was the controlling shareholder's misappropriation of the proceeds of the corporation's sale of its portfolio securities, despite the reference to that very situation in the Code commentary.¹⁴² Moreover, section 1709 would probably not include the situation in which

135. ALI FEDERAL SECURITIES CODE § 1603, Comment 3(a)(v) (Proposed Official Draft 1978).

136. *Id.* Comment 3(a)(vi).

137. Subsections (a) and (b) of § 1702 distinguish between transactions effected on the open market and other transactions. ALI FEDERAL SECURITIES CODE (Proposed Official Draft 1978). With respect to nonmarket transactions, privity is required. *Id.* § 1702(a).

138. *See, e.g.,* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), in which the transaction that triggered federal liability was a sale to a nonparty by the corporation on whose behalf the action was brought.

139. ALI FEDERAL SECURITIES CODE § 1709 (Proposed Official Draft 1978).

140. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

141. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

142. ALI FEDERAL SECURITIES CODE § 1603, Comment 3(a)(vi) (Proposed Official Draft 1978).

the fiduciary and corporation engaged in a damaging nonsecurities transaction and suit is brought by stockholders who bought or sold in the market without disclosure of the transaction. Since neither of these situations is within the ambit of section 1702, it is possible that, despite the attempt to broaden liability by removing the purchaser-seller requirement from section 1709, some situations clearly covered under current law would not be covered under the Code.

However extensive the Code's express remedy provisions are ultimately construed to be, it is unlikely that Code protection could be expanded substantially beyond these provisions through the implied remedy provision, section 1722. That section permits implication of a remedy when the action is "not inconsistent" with any express remedies, the plaintiff and the harm are within the protection of the provision from which implication is being made, and the remedy is "not disproportionate" to the violation.¹⁴³ The last two tests mentioned would not prevent a wider mismanagement remedy. The first would present a stumbling block, however, because broad implied remedies in the mismanagement context or for a face-to-face transaction between plaintiff and defendant would be inconsistent with the restrictive remedies created expressly for those situations in sections 1709 and 1703.¹⁴⁴

E. *Summary of Questions Posed by the Current Law*

The above discussion has served to identify the unanswered questions about the scope of federal liability for corporate transactions arising from cases decided under the current federal securities laws and from an interpretation of the Federal Securities Code. Since the remainder of the Article proposes answers to these questions, it would be helpful at this point to summarize them.

First, it is not clear whether federal law goes beyond its basic function of regulating the extent of disclosure to impose also any of the substantive fiduciary duties that are usually the subject of state law. Lower federal courts have examined cases involving (1) misleading of the decision maker

143. This implied remedy rule may be broader than the currently applied Supreme Court rule discussed at notes 148-50 *infra* and accompanying text. Since the Supreme Court's test is intended only to divine the meaning of the statute, it is clear that the Code test would control implied liability under the Code, even if it is inconsistent with the Court's general rule.

144. In *Cannon v. University of Chicago*, 441 U.S. 677, 711 (1979), the Court stated that the existence of express remedies in a statute is not, in itself, sufficient reason to hold that an implied remedy would be inconsistent with the statute (interpreting § 901(a) of title IX of the Education Amendments of 1972, 20 U.S.C. § 1681 (1976)). In the context of the Federal Securities Code, however, in which an express private damage remedy is given for specific misconduct, implication of an additional private damage remedy with respect to the same misconduct would almost certainly be inconsistent with the statute. By comparison, the only "express remedy" in *Cannon* was termination of federal funds rather than private relief. A case that presents a situation more comparable to the implied action for corporate mismanagement is *Levy v. Johnson*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,899 (S.D.N.Y. 1977), in which the court refused to imply a cause of action under rule 10b-5 for false filings that were specifically remediable under § 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r (1976).

of the corporation; (2) imposition of a duty to disclose when the corporate directors or officers have breached a fiduciary duty to the corporation; and (3) liability for breach of a substantive duty without the presence of a non-disclosure or misrepresentation. Some of the cases clearly rest liability on one of these grounds, while others involve two or more. The question presented by these cases is which of these situations survives as an appropriate basis for federal liability after *Santa Fe*, or would continue to survive if the current draft of the Federal Securities Code is adopted.

Several subsidiary questions follow the answer to this basic question. To the extent that federal liability is based upon breach of a substantive duty, it is not clear what this duty is. For example, there is confusion in the lower court cases, which is not addressed by either the Code or *Santa Fe*, as to whether the duty is limited to directors with a direct pecuniary conflict of interest, or also includes directors who are subject to more indirect pressures that may impair their judgment. To the extent that liability is based on lack of disclosure, it is not clear what materiality and causation rules should apply in the context of corporate transactions.

Finally, confusion exists as to the requisite role of a purchase or sale of securities. Under case law, the "in connection with" requirement includes (1) a purchaser-seller standing requirement; and (2) a connection between the purchase or sale and the fraud. The looseness of these rules, and the anomalous distinctions between those federal mismanagement cases that involve a security transaction and those that do not, raise the question of whether these requirements should be preserved at all. The Code perpetuates all of this case law insofar as the definition of an unlawful act is concerned, but its express remedy provisions raise problems of their own.

III. AN APPROACH TO RESOLVING THE QUESTIONS

A. *In General*

The first step in answering the questions posed in the preceding section must be to identify the controlling considerations. The primary reference point with respect to both the express remedy under the Federal Securities Code and the implied remedy under the current law is the statute. Federal courts must be particularly careful to avoid viewing the implied remedy action as their own creation and endowing it as generously as a parent would his own child. Federal court jurisdiction in nondiversity cases, unlike that of state courts, must find its source in specific legislation or the Constitution.¹⁴⁵ Moreover, federal courts, like state courts, should be wary of their ability to make basic policy judgments and create new remedies without legislative guidance.¹⁴⁶ Thus, while the question in a state court mismanagement case may be one of adjusting duties among the various groups in the corporation in order to achieve optimum equity, in a federal

145. 28 U.S.C. § 1331(a) (1976).

146. See *Cannon v. University of Chicago*, 441 U.S. 677, 730, 742-49 (1979) (Powell, J., dissenting).

mismanagement case the question is the more complicated one of determining the duties that are imposed by the applicable statute.¹⁴⁷

Mindful of these considerations, the Supreme Court has been demanding increasing adherence to the letter and intent of the statute in its recent implied remedy cases. Earlier cases recognized that a remedy could be implied provided it was consistent with a federal statute.¹⁴⁸ More recent opinions have emphasized statutory intent in implied remedy cases, while also looking at other policy considerations.¹⁴⁹ The most recent Supreme Court cases have relied solely on legislative intent.¹⁵⁰

In the present situation, however, it is the statute that created the questions, and it, alone, cannot furnish the answers. The language of the general antifraud sections presents terms like "deceptive," "fraudulent," "manipulative," and "in connection with the purchase or sale of any security." "Deceptive" could be construed to include only verbal misrepresentations, or could also include nonverbal conduct, and even conduct involving full disclosure having the effect of deception by depriving a shareholder of the full use of his vote.¹⁵¹ "Fraudulent" is even more ambiguous, since it carries clear overtones of conduct beyond misrepresentations,¹⁵² but it could also be as limited as "deceptive." "Manipulative" need not be limited to market-rigging in the traditional sense, but could include the artful timing of truthful announcements in order to affect the exchange ratio of a merger, or the structuring of a transaction by majority shareholders so as to leave no choice to the minority.¹⁵³ Finally, the varia-

147. Thus, Professor Campbell's criticism of *Santa Fe's* limitations upon the federal mismanagement cause of action, *supra* note 35, at 193, to the effect that *Santa Fe* leaves shareholders inadequately protected, does not go far enough to rebut the Court's position that any further protection must come from a different statute. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 480 & n.17 (1976) (citing Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974)).

148. Compare *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975), and *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453 (1974) (applying the rule to deny an implied remedy), with *Bivens v. Six Unknown Named Agents*, 403 U.S. 388 (1971), and *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (applying the test to support an implied remedy).

149. *Cannon v. University of Chicago*, 441 U.S. 677, 689-709 (1979) (20 U.S.C. § 1681 (1976)); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-80 (1977) (15 U.S.C. § 78j(b) (1976)); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 24-42 (1977) (15 U.S.C. § 78n(e) (1976)); *Cort v. Ash*, 422 U.S. 66, 74-85 (1975) (18 U.S.C. § 1610 (1976)). For analysis of the Supreme Court's changing approach to implied right actions, see Pillai, *Negative Implication: The Demise of the Private Right of Action in the Federal Courts*, 47 U. CIN. L. REV. 1 (1978); Note, *Implication of Private Actions from Federal Statutes: From Borak to Ash*, 1 J. CORP. L. 371 (1976).

150. *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 100 S. Ct. 242, 249, 62 L. Ed. 2d 146, 157 (1979); *Touche Ross & Co. v. Redington*, 99 S. Ct. 2479, 2489, 61 L. Ed. 2d 82, 96 (1979). See also *Cannon v. University of Chicago*, 441 U.S. 677 (1979) (Powell, J., dissenting).

151. See 1 A. BROMBERG, *supra* note 13, § 4.7(540); Jacobs, *supra* note 21, at 14-15; ALI FEDERAL SECURITIES CODE § 225, Comment 2 (Tent. Draft No. 2, 1973).

152. See text accompanying notes 47-49 *supra*. See also *Going Private Transactions by Public Companies or Their Affiliates*, Securities Act Release No. 33-5884, Exchange Act Release No. 34-14185, Investment Company Act Release No. IC-10015, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366.

153. See *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1295-96 (2d Cir. 1976) (Mans-

tions of the "in connection with" requirement were discussed in section II.D.

The specific language of section 10(b) being unavailing, some help may be derived from viewing these provisions in the context of the overall legislative framework of the 1934 Act. A strong initial argument, as outlined in *Santa Fe*,¹⁵⁴ is that the fundamental purpose of the 1933 and 1934 Acts was to require disclosure.¹⁵⁵ Certainly the general scope and the legislative history of these laws evidence an intent to regulate corporate conduct through the limited method of requiring disclosure in securities transactions.¹⁵⁶ The Federal Securities Code has not made any basic changes in this approach. On the other hand, there is a strong argument in favor of interpreting the federal cause of action under both the current law and the Code to extend beyond a disclosure requirement: If the federal securities laws are to operate as a complete scheme of investor and stock market protection, there should be a federal cause of action under the general anti-fraud provisions for any conduct that threatens the integrity of the stock markets, including mistreatment of shareholders, whether or not there has been any defect in disclosure.¹⁵⁷ The general legislative context of the antifraud provisions therefore presents the courts with a choice between accomplishing the overall goal of the securities laws to protect investors and the integrity of the stock markets or a strict application of the specific means chosen by the legislature to achieve that goal. Unless the choice is made, none of the questions posed in the preceding section may be answered.

The solution to this quandry that would best reflect the spirit of the securities laws would be to attempt to achieve the goal of the securities laws through a cause of action that required both a failure to disclose and a related purchase or sale of securities. Even if that solution is accepted, there remains the question of whether the lack of disclosure and the purchase or sale must have been important aspects of the transaction, or whether there need have been only some minimal nondisclosure and connection with a securities purchase or sale.

In conclusion, therefore, although the statute must control both the im-

field, J., concurring), *rev'd*, 430 U.S. 462 (1977); 5A A. JACOBS, *supra* note 120, § 139.05(c); Rosenfeld, *An Essay in Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries*, 5 HOFSTRA L. REV. 111, 131 (1976). *But see* Alabama Farm Bureau Mut. Cas. Ins. Co. v. American Fidelity Life Ins. Co., 606 F.2d 602 (5th Cir. 1979), and *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349 (N.D. Tex. 1979) (restricting "manipulative" to its traditional market-rigging sense).

154. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

155. *Id.* at 478.

156. *See* Banoff, *Fraud without Deceit: Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, Inc.*, 17 SANTA CLARA L. REV. 1 (1977); Sherrard, *Fiduciaries and Fairness under Rule 10b-5*, 29 VAND. L. REV. 1385, 1425 (1976).

157. *See* Bloomenthal, *supra* note 63, at 351-52; Cary, *supra* note 147, at 700 (arguing for additional legislation rather than coverage under § 10(b)); Fleischer, *supra* note 63, at 1174-75; Folk, *supra* note 11, at 805-12; Comment, *supra* note 11, at 1117-18. *See also* *United States v. Naftalin*, 441 U.S. 768 (1979), in which the Supreme Court extended § 10(b)'s protection to broker-plaintiffs, noting the broad purposes of the securities laws and that the "welfare of investors and financial intermediaries are inextricably linked." *Id.* at 776.

plied and express remedy actions, the statutory language leaves the questions posed in part II unanswered. It is not clear whether there should be liability for undisclosed mismanagement; when the duty to disclose, if any, should arise; what standards of materiality and causation should apply; or what is the required role of the securities purchase or sale. To answer these questions, it will, after all, be necessary to look to policy considerations apart from the statutes. This would not be inconsistent with the recent Supreme Court strictures against going outside the statute.¹⁵⁸ Even *Touche Ross & Co. v. Redington* did not hold that the courts may not look to policy when the statute itself is unclear.

B. *Extrinsic Policy Considerations*

The recent Supreme Court cases involving implied statutory causes of action¹⁵⁹ have indicated that whether the cause of action lies in an area "traditionally relegated to state law"¹⁶⁰ is important in determining the existence and scope of a federal remedy. The opinions give only the barest clues as to what this means and how this policy is to be applied. The states have traditionally regulated corporations very broadly, but clearly some of this field is of appropriate federal concern. The opinion in *Santa Fe* refers to state regulation of fiduciary duties. Does this mean that the federal courts should not regulate insider fiduciary duties at all? *Bankers Life* indicates that some regulation of internal corporate conduct is permissible, so long as there is an element in the transaction that makes it a federal concern.¹⁶¹ What is this element?

The only way to answer these questions is to consider the reasons favoring state regulation of an area, and then apply them to determine precisely how the existence of state regulation should limit the federal remedy for corporate mismanagement.

(1) *Judicial Economy*. In *Santa Fe* the Court noted that the plaintiff had an alternative nonfederal remedy in the Delaware appraisal remedy, and it further pointed out the danger of a "widely expanded class of plaintiffs"¹⁶² if a federal remedy were granted in corporate mismanagement

158. See text accompanying notes 148-50 *supra*.

159. In *Touche Ross & Co. v. Redington*, 99 S. Ct. 2479, 2489, 61 L. Ed. 2d 82, 95-96 (1979), the Court simply stated that there is no need to look to extrinsic policy factors when the legislative intent is clear. After identifying a clear legislative intent, the Court refused to recognize an implied cause of action based upon § 17(a) of the 1934 Act, 15 U.S.C. § 78q(a) (1976).

160. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478 (1977) (quoting *Cort v. Ash*, 422 U.S. 66, 78 (1975)).

161. In *Bankers Life*, in upholding a complaint alleging looting by a controlling person, the Court said: "We agree that Congress by § 10(b) did not seek to regulate transactions which constitute *no more than* internal corporate mismanagement. But we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities" *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (emphasis added).

162. 430 U.S. at 479 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975)).

cases. These considerations indicate a concern with judicial economy, or the proper allocation of the limited resources of the federal courts.

This consideration is of limited value. The effect on the federal courts' caseload and the ability of plaintiffs to obtain relief elsewhere are, of course, important considerations. It is not enough to say, however, that state law gives a remedy. The fact that the plaintiff wants federal relief indicates that the state remedy is not as complete as the federal remedy, either because the state does not provide a cause of action for certain conduct¹⁶³ or because it imposes procedural impediments.¹⁶⁴ It remains necessary to balance the importance of providing federal relief against the problems of allocating federal judicial resources for this purpose.¹⁶⁵

(2) *Interference with State Law.* *Santa Fe* also considers whether federal regulation would "interfere with state corporate law";¹⁶⁶ that is, whether state policies of corporate regulation would be overridden. This consideration should also be given little weight. Interference is only a problem to the extent that federal duties of corporate managers or majority shareholders would be higher than state duties or are more easily enforced, since stricter state duties will retain preeminence. It is difficult to understand how higher federal duties can actually interfere with or undermine state policies. Higher federal duties may circumscribe the field of action of corporate managers, but this affects the interstate business of the corporation as a whole, and does not affect the state of incorporation in any special way. Higher federal duties imposed nationwide upon all corporations subject to the jurisdiction of the federal securities laws will, of course, remove the attraction of a state's liberal corporation statute to incorporators, and thus hinder the state's competition for incorporating businesses. This should not, however, be a substantial concern of the federal courts.¹⁶⁷

163. *E.g.*, the standard applied in some states for determining when a transaction falls under an "interested director" cloud is lower than that applied in some 10b-5 cases. *Compare* Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir.) (en banc), *cert. denied*, 395 U.S. 906 (1969) (duty to disclose even when interested directors abstained), *with* DEL. CODE ANN. tit. 8, § 144(1) (Rev. 1974) (interested director transaction not void or voidable solely because of that fact when transaction approved without counting interested director's vote).

164. The procedural advantages of the federal action include:

(1) avoidance of a state security-for-expense statute in a derivative action; *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961);

(2) availability of nationwide service of process and a venue choice in any district where any part of the "act or transaction" occurred; 15 U.S.C. § 78aa (1976); *Zorn v. Anderson*, 263 F. Supp. 745 (S.D.N.Y. 1966);

(3) access to the more liberal class action device provided by FED. R. CIV. P. 23. *But see* *Eisen v. Carlisle & Jacquelin* (Eisen III), 417 U.S. 156 (1974) (individual mailed required notice to class members at plaintiff's expense); and

(4) availability of jury trial in a derivative suit; *Ross v. Bernhard*, 396 U.S. 531 (1970). *See generally* R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 992-94 (4th ed. 1977).

165. *See* *Bivens v. Six Unknown Named Agents*, 403 U.S. 388, 410-11 (1971) (Harlan, J., concurring).

166. 430 U.S. at 479.

167. *See generally* Cary, *supra* note 147.

Aside from the intrinsic validity of these first two policies, they cancel each other out in terms of providing a test for the application of federal law: "Judicial economy" would support denial of a federal cause of action when there is a state remedy, "interference" only when there is not.

(3) *Uniformity.* If the states have traditionally regulated in an area, there may be as many different approaches to the problem as there are state jurisdictions. To the extent that there is a need for a uniform approach, either to facilitate interstate commerce or to effectuate an important national concern, as with respect to nationwide tender offers,¹⁶⁸ the need will be best served by having the matter regulated by the federal courts. Uniformity has been regarded as an important consideration in favor of expansion of federal securities law remedies.¹⁶⁹

(4) *Deference to State Policy Judgments.* To the extent that the federal courts venture away from statutory language and make judgments as to whether there should be a federal remedy, they are straying into the policy-making arena of the legislature.¹⁷⁰ Although the courts must decide some policy issues, they should be particularly careful when the policy judgments are of the same type as have been traditionally made by the states. In view of general state regulation in the area, lack of a state remedy for certain internal corporate conduct constitutes a judgment as to the importance of having *any* remedy. Because of the extensive experience of state courts and legislatures in corporate regulation, and the slow evolution of a large body of law in the area, the federal courts should give considerable weight to the state policy judgment. This is a much more substantial consideration than judicial economy. The point here is not simply that federal judicial resources should not be spent, but that the federal court, because of its comparative lack of expertise, risks making the wrong policy judgment when it second-guesses the state.¹⁷¹

(5) *Predictability.* Corporate law is an area in which behavior is planned with a view to what the law is; thus, it is particularly important that the law be easily determinable. Uniformity of the law among jurisdictions often makes the law more predictable, but this is not always so. Paradoxically, superimposing federal regulation upon an area traditionally regulated by the states may actually make the law applicable to a given situation more difficult to determine. Determining which state law applies to a substantive corporate management question is usually straightforward since, in the vast majority of cases, it is the law of the state of incorporation.¹⁷² Even though other states may have an interest in the result, it is

168. See *Great W. United Corp. v. Kidwell*, 577 F.2d 1256 (5th Cir. 1978), *rev'd on other grounds sub nom. Leroy v. Great W. United Corp.*, 99 S. Ct. 2710, 61 L. Ed. 2d 464 (1979).

169. See I A. BROMBERG, *supra* note 13, § 4.7(514)(2); Campbell, *supra* note 35, at 194; ALI FEDERAL SECURITIES CODE § 1721, note 6 (Proposed Official Draft 1978).

170. See text accompanying note 146 *supra*.

171. See Dyer, *supra* note 54, at 16-22.

172. See R. LEFLAR, *AMERICAN CONFLICTS LAW* § 253 (3d ed. 1977); Reese & Kauf-

precisely because of the need for predictability that the law of the incorporating state governs.¹⁷³ In some cases, particularly those involving pseudo-foreign corporations that are located almost exclusively in one state, a different law has been applied,¹⁷⁴ but the situations in which this will occur are notorious enough that predictability is not a problem.¹⁷⁵ The law within a given state jurisdiction is normally determinable with some accuracy, since it is found in a fairly precise statute, the interpretation of which is controlled by the state's highest court.

Federal law, on the other hand, is not so easily determinable. As discussed above, the general language of section 10(b) provides little specific guidance, and there is little coherent federal case law on any given mismanagement question. The interpretive rules are supplied by different courts of appeals, and any number of courts might have jurisdiction over a given corporation. This inconsistency among courts cannot wholly be resolved by the Supreme Court, since the Court cannot address the myriad mismanagement questions that could arise. Finally, even if the state law on a given subject is not easily determinable and the federal law is, the fact will remain that superimposing the federal duty on the state duty cannot help but complicate an already difficult situation.¹⁷⁶

The need for predictability in federal corporation law has been noted by several commentators.¹⁷⁷ Although the Court did not specifically refer to the predictability problem in *Santa Fe*, it may have been alluding to it in expressing a concern that a federal remedy would interfere with state policies. The Court may not have been concerned about the actual substance of existing state policies, but about the fact that the policies were "established," and therefore predictable. Predictability has also been a prominent factor in choice of law questions and has been cited as important in choosing the law applicable to internal corporate affairs.¹⁷⁸ Although the issue of federal liability for mismanagement is inherently one of jurisdiction rather than choice of laws, federal jurisdiction does carry with it the power to determine the applicable law,¹⁷⁹ and thus has important choice of

man, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 1118, 1125 (1958).

173. See Reese & Kaufman, *supra* note 172, at 1126-27.

174. *Mansfield Hardwood Lumber Co. v. Johnson*, 268 F.2d 317 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959); *Western Air Lines Inc. v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (Dist. Ct. App. 1961).

175. One solution to lax state laws would be to apply the laws of states with more protective corporation codes whenever these states have some contact with the corporation. See, e.g., CAL. CORP. CODE § 2115 (West Supp. 1979). This approach would be very similar to compensating for lax corporation laws through the application of federal law, both from the standpoint of protecting shareholders and of interfering with the policy of predictability.

176. See Sherrard, *supra* note 156, at 1419.

177. Fleischer, *supra* note 63, at 1179; Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391, 395; Sherrard, *supra* note 156, at 1420; Note, *supra* note 21, at 1889-97.

178. See text accompanying notes 172-75 *supra*.

179. See Mishkin, *The Vastness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797 (1957).

law implications.

C. *Conclusions Regarding Approach to Resolving the Questions*

Although federal implied remedy actions should, in general, be limited by the statutes on which they are based, the application of the federal securities laws to corporate transactions cannot be determined so easily. The actual language of the statute is ambiguous, and an analysis of legislative intent reveals a conflict between the broad goal of protecting investors and the narrow disclosure-oriented means adopted to achieve this goal. Thus, the statute itself reveals only that a line must be drawn between federal securities law and state regulation of corporate mismanagement, and not where that line should be drawn. It is necessary, therefore, to turn to some nonstatutory policy considerations. An examination of these policies reveals that federal liability should be limited by state regulation of corporate governance if, in view of such regulation, federal rules would make the law less predictable, would have a substantial chance of being inconsistent with a long-developed state scheme, and if nationwide uniformity is not essential.

In the next part of the Article, these conclusions will serve as the basis of a rational scheme of federal regulation of corporate transactions.

IV. A SCHEME OF FEDERAL REGULATION OF CORPORATE TRANSACTIONS

A. *An Overview*

(1) *Disclosure Versus Substantive Duties.* As noted in section II.A.(1) of this Article, there is an important question in the federal mismanagement cases as to how extensive federal substantive fiduciary duties should be, if any. Application of the policies discussed above permits an answer to this question: Federal law should not become involved in the imposition of such duties.

Substantive fiduciary duties have long been one part of corporate law that is especially the province of state law, giving good reason for the federal courts to defer to state policy judgments in this area. Also, since there is already established state law as to substantive fiduciary duties, but no equally-developed federal law, superimposing federal duties on state regulation would adversely affect predictability. The predictability problem is evident when one considers the discussion in section II.B. of the wide variety of decisions that have been reached by the federal courts with respect to substantive fiduciary duties. With respect to uniformity, since the internal conduct of corporations is subject to the law of only one state, there is not the need for a single federal rule as there is, for example, for tender offers. Although the important federal goal of investor protection is involved, regulation of corporate mismanagement is only one means to this end. Therefore, the federal policy being served here is not nearly as im-

portant as, for example, voting rights or fair employment,¹⁸⁰ and is not sufficient to override the other policies favoring deference to state law.

The existence of state corporate regulation is less significant, however, with respect to disclosure rules. The important disclosure standards have been developed under federal law. In fact, it was the weakness of state disclosure rules that made the federal securities laws necessary. Therefore, federal courts need not defer to state court policy decisions with respect to disclosure standards, and a federal disclosure duty would not create unpredictability. Moreover, since the question whether the defendant has made adequate disclosure does not involve so much a choice from among many distinct and competing policy decisions as it does a subtle analysis of the facts, rules concerning the adequacy of disclosure are not as important in guiding the choices of businessmen as are rules concerning substantive duties.

(2) *Breach of Fiduciary Duty Coupled with Total Nondisclosure.* The above discussion does not address the question of whether federal liability should be imposed in cases involving nondisclosed mismanagement. The question of liability in this situation could not be answered under the language and general context of the statutes alone, since it could be argued with equal force under the statutes both that the nondisclosure is a matter of federal interest and that the breach of fiduciary duty aspect of the case removes it from the reach of the federal statutes.

Under the foregoing policy analysis, however, the balance tips against liability for nondisclosed mismanagement. So long as a court is recognizing a substantive fiduciary duty, it makes little difference from the standpoint of the above policies whether the duty is one not to engage in the transaction, or one to make a disclosure about it. In either case, the court must decide which transactions trigger a certain duty, and so make a policy judgment on a matter traditionally regulated by the state.

By contrast, when information concerning a damaging corporate transaction has been submitted to the decision-making body and the transaction is approved because of the inadequacy of the disclosure, a federal cause of action is proper. The court is deciding simply how much must be disclosed, rather than that a given transaction triggers a certain duty. Even if the damaging transaction is a cause-in-fact of the liability, the important fact is that the court would merely be establishing a standard of disclosure. It would not, therefore, be intruding on a state area.

The policy problems posed by a federal duty to disclose are clearly demonstrated by the duty to disclose cases discussed in section II.B.(2) above. The courts in these cases are making differing judgments about the types of corporate transactions for which a federal duty should lie, and so are creating a risk that the governing legal rules will be inconsistent and unpredictable. Instead of being able to look simply to the single set of legislative and judicial rules of the state of incorporation before determin-

180. See *Cannon v. University of Chicago*, 441 U.S. 677 (1979).

ing their course of action, corporate managers and directors are forced to determine how to comply with the parallel federal standard, which may be difficult in light of the conflicting judgments of the various federal circuits able to exercise jurisdiction over the corporation. Additionally, there is a serious question as to the propriety of federal court policy judgments when they are contrary to well-established state authority.¹⁸¹

The only way to eliminate the problems of a federal duty to disclose would be to eliminate the duty. The problems could be reduced, for example, by defining the causation requirement as precisely as possible,¹⁸² so that managers would have the maximum amount of notice as to when conduct creates a risk of federal liability. There are, however, limits on the degree to which causation may be made precise.¹⁸³ Even making the federal duty to disclose coextensive with the state duty would not be a total solution. There would remain the risk of federal interpretations of the state duty that are inconsistent with those of the state courts, as well as such difficult questions as whether the federal courts must determine that a state action would have been successful, or simply that a *prima facie* case could be presented.¹⁸⁴

Eliminating federal liability for total nondisclosure of damaging corporate transactions is subject to the criticism that the specific federal goal of ensuring disclosure would be compromised. One response to this argument is that the total amount of meaningful disclosure will not be greatly reduced under such a rule. State statutory and common law will continue to require that transactions entered into by interested directors¹⁸⁵ or involving certain fundamental corporate changes be approved by shareholders. Federal rules require complete disclosure in connection with these shareholder votes whether or not proxies are solicited.¹⁸⁶ Existing express¹⁸⁷ and implied¹⁸⁸ federal disclosure requirements also ensure disclosure either before or shortly after the transaction. Moreover, the rule proposed here is not far removed from the current state of the law. There is a definite post-*Santa Fe* trend away from federal liability for total failure to disclose,¹⁸⁹ and what liability remains is too vague and uncertain to

181. There are substantive policy decisions to be made in connection with a duty to disclose apart from the decision as to whether any disclosure must be made, including the timing of any such disclosure. See Sherrard, *supra* note 35, at 710-15.

182. See Note, *supra* note 21, at 1883-85, suggesting a precise causation requirement as a way of facilitating nondisclosure liability.

183. See section II.C. *supra*.

184. See text accompanying notes 87-89 *supra* and 218-19 *infra*.

185. See, e.g., Delaware General Corporation Law § 144, which provides that transactions approved by interested directors shall not be voidable or void on account of conflict of interest if, *inter alia*, the transaction is approved by the shareholders. DEL. CODE ANN. tit. 8, § 144(a)(3) (Rev. 1974).

186. 15 U.S.C. §§ 78m(a)-(c) (1976) (Securities Exchange Act of 1934, §§ 13(a)-(c)).

187. See 15 U.S.C. § 78i (1976) (Securities Exchange Act of 1934, § 12).

188. See text accompanying notes 266-67 *infra*.

189. See the discussion of *Goldberg v. Meridor* at notes 23-26 *supra*; *Siegel v. Merrick*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,887 (S.D.N.Y. 1979) (allegations of nondisclosure to the shareholders dismissed as not involving deception); and the director-election cases, discussed in section IV.C.(3). The director election-decisions indicate that

provide much incentive to disclose.

To a certain extent, of course, eliminating federal liability for total failure to disclose would reduce federal protection of shareholders against corporate mismanagement. This is, however, fully justifiable under the existing law and under the proposed Code. Eliminating nondisclosure liability is consistent with a narrow view of the language and general context of the statutory provisions themselves. Taking a narrow view of the statute is compelled, in turn, by the policy considerations discussed above.¹⁹⁰ The solution to the problem of reduced shareholder protection is not judicial expansion of coverage under the existing federal statutes, but a radically different statute.¹⁹¹

(3) *The Extent of Liability for Misrepresentation.* It has been established that federal liability for damaging corporate transactions may be based only on a failure to disclose as distinguished from breach of a substantive fiduciary duty. The question is the extent of federal liability for failure to disclose. It is necessary to develop materiality and causation standards, as well as to distinguish between cases involving breach of a disclosure duty and those involving breach of a substantive duty.

Although these matters will be specifically discussed in sections IV.B. and C. below, certain general considerations that derive from the above discussion should be noted. First, the materiality rules should be adjusted to minimize the disincentive to disclose that will be created by eliminating liability for total nondisclosure. In other words, the materiality threshold should not be so low as to influence corporate managers in close cases to avoid courses of action requiring disclosures to shareholders. Secondly, both materiality and causation requirements should be devised to ensure that liability is, indeed, based upon the failure to make adequate disclosure, rather than in fact upon breach of substantive fiduciary duties.

(4) *Role of the Securities Transaction.* As will be more fully developed in section IV.D. below, a close look at the statute and the governing policy considerations¹⁹² justifies an abandonment of the anomaly of conditioning federal liability for corporate transactions upon the presence of a securities transaction. If the transaction is one affecting shareholders in a public corporation¹⁹³ and the qualifications discussed above are met, neither the terms of the statute nor policy considerations require a denial of federal liability. The decisions interpreting section 10(b), including those denying liability, are generally consistent with this analysis. The proposed Federal Securities Code should be interpreted as liberally as pos-

post-*Santa Fe* plaintiffs perceive a necessity to allege something more than mere nondisclosure. See also Campbell, *supra* note 35, at 192 (arguing that the nondisclosure to shareholders theory is not really "deception" and is a "defection" from the rationale of *Santa Fe*).

190. See text accompanying notes 159-79 *supra*.

191. See Conclusion, section V *infra*.

192. See text accompanying notes 159-79 *supra*.

193. See text accompanying note 232 *infra*.

sible to yield the same result, and should be revised to the extent that it is inconsistent.

(5) *The Corporate-Market Distinction.* Both a general view of the language of the federal antifraud statutes and the governing policy considerations support a broad distinction between liability for "corporate" transactions, which involve the internal affairs of the corporation and the relationship among the corporation, its managers, and its stockholders, and "market" transactions, which focus solely upon the purchase or sale of stock by the individual investor.¹⁹⁴

From the standpoint of the 1934 Act, regulation of activities directed toward the market is not limited to disclosure, but extends also to close substantive regulation of market participants.¹⁹⁵ Moreover, market activities are given much more attention in the 1934 Act than is protection of shareholders as such. With respect to extrinsic policy considerations, there is a much greater need for uniformity of regulation of interstate securities markets than of internal corporate affairs.¹⁹⁶ Even a corporation with nationwide organization and operation is subject to the law of only one state as to its internal affairs, but a securities trader in an interstate market is subject to the laws of many jurisdictions. Additionally, since market activities have traditionally been regulated under federal rather than state law, federal liability does not interfere with predictability, and does not pose a risk of inaccurate policy judgments.

For all these reasons, federal liability connected with market transactions need not be limited to breach of a disclosure duty. Indeed, the courts have displayed a much greater willingness to go beyond disclosure in market cases than they have in corporate cases.¹⁹⁷ Although it is beyond the scope of this Article to explore which duties should be imposed in market cases, it is pertinent to consider where the line should be drawn between "market" and "corporate" transactions.

Having summarized the consequences of section III's analysis upon the

194. The distinction between the applicability of federal law to corporate and market transactions has been noted by some courts and commentators. See *Herpich v. Wallace*, 430 F.2d 792, 808 (5th Cir. 1970); *O'Neill v. Maytag*, 339 F.2d 764, 768-69 (2d Cir. 1964); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 300 F. Supp. 1083, 1101 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971); *Jacobs*, *supra* note 21, at 29. Some courts and commentators, however, have cited the recognition of liability in some market-oriented cases as authority for liability without regard to disclosure in corporate situations. For example, *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), was heralded as broadening the general concept of fraud under § 10(b), despite the fact that the case involved "free riding," or the placing of orders with brokers without intending to pay for the stock unless it went up—a strictly market-oriented transaction. See *Entel v. Allen*, 270 F. Supp. 60, 70 (S.D.N.Y. 1967); *Bloomenthal*, *supra* note 63, at 342-43; Note, *supra* note 11, at 1019-20.

195. See 15 U.S.C. §§ 78g, 78h, 78k, 78o & 78o-3 (1976) (Securities Exchange Act of 1934, §§ 7, 8, 11, 15 & 15A), regulating the activities of brokers and dealers.

196. ALI FEDERAL SECURITIES CODE § 1721, note 6 (Proposed Official Draft 1978).

197. *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967).

scope of federal liability for corporate transactions, we now turn to a more detailed discussion of the proposed scheme of liability.

B. *Basis of Liability: Adequacy of Disclosure Versus Substantive Regulation*

Under the analysis proposed here, federal liability for corporate transactions may not be based on breach of a substantive fiduciary duty, even if this breach of duty is not disclosed to shareholders. How is this kind of case distinguishable from one in which the imposition of federal liability would be proper? This problem may be analyzed by dividing corporate transaction cases into three categories based on the context in which the misrepresentation or nondisclosure arose: (1) misleading of shareholders through proxy materials or other general disclosure materials, when the shareholders are the decision-making body; (2) misleading of some members of the board of directors, either by outsiders or by other members of the board, when the board is the decision-making body;¹⁹⁸ (3) failure to make disclosures to the shareholders when the decision is made by a fully-informed board of directors.

The first situation should be remediable under federal law, whether the misleading act consists of a false statement or a failure to disclose facts. Under existing federal securities law an omission to state facts constitutes a "misrepresentation" if the omission makes what has been said misleading.¹⁹⁹ There would clearly be a misrepresentation if, for example, a listing of outstanding loans in a proxy statement or annual report purporting to be complete omits items that belonged in the list. The same shareholder expectations of completeness that justify classifying such an omission as a misrepresentation arguably would exist whenever a material fact is omitted from an affirmative statement to shareholders, although there is authority against this broad position.²⁰⁰ More importantly, notwithstanding whether an omission in this situation is technically considered misrepresentation or nondisclosure, policy dictates that it should be remedied under federal law. Misleading the market and shareholders through press

198. Cases that might belong in this category are: *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *Condon v. Richardson*, 411 F.2d 489 (7th Cir. 1969); *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964); *Hoff v. Sprayregen*, 339 F. Supp. 369 (S.D.N.Y. 1971); *Weber v. Bartle*, 272 F. Supp. 201 (S.D.N.Y. 1967). In *Bankers Life* the entire board of directors was apparently deceived; the board, however, was under the control of the benefitting party. 404 U.S. at 8 n.1. In the other cases there were allegations that a majority of the board of directors deceived a minority of directors, but the language of the opinions did not make clear whether the basis of liability was the misleading of the minority of the board or nondisclosure to the shareholders. Since only the former theory would be a proper basis of federal liability, there must be a causative connection between the misleading of the directors and the harm. See the causation discussions in section II.A.(3) *supra*, and in section IV.C.(2) *infra*.

199. See 15 U.S.C. § 77q(a)(2) (1976) (Securities Act of 1933, § 17(a)(2)); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979).

200. See *Perelman v. Pennsylvania Real Estate Inv. Trust*, 432 F. Supp. 1298 (E.D. Pa. 1977).

releases or proxy statements is precisely the kind of activity traditionally regulated under federal, rather than state, law.

By contrast, the third situation listed above should certainly not come within federal law. Here the duty to disclose is triggered only by a breach of some kind of substantive fiduciary duty, a duty properly regulated by state law. Imposing disclosure liability in this situation is indistinguishable, insofar as the relevant policies are concerned, from imposing liability for the breach of substantive duty in the transaction itself.

It is the second situation that presents some difficulties. If directors have made some affirmative statements containing material omissions, there would be a misrepresentation even in the technical sense, and federal liability would seem to be clearly in order. Cases in this category may arise, however, in which there is not an affirmative statement from which to imply a misrepresentation of completeness. Liability in such face-to-face nondisclosure cases has been said to rest on fiduciary principles,²⁰¹ and so may be inappropriate for federal adjudication. Certainly the federal concern is much less apparent in these face-to-face situations than in the cases in the first category.

On the other hand, it has been argued that these cases involve a tacit misrepresentation, or "active fraud," as opposed to breach of an affirmative duty to disclose.²⁰² In the face-to-face situation, the duty may be said to be based upon active reliance by one party on the other, as in a misrepresentation case, rather than on the nature of the act engaged in by defendant, as in a fiduciary duty case. On balance, therefore, it would seem that there should be federal liability in this situation, provided the cause of action is, in fact, based on the misleading of the minority directors by the majority or outsiders.²⁰³

As a practical effect of the foregoing distinctions made in imposing federal liability, corporate managers will need only look to state law in determining whether to enter into or how to structure a transaction, including whether any disclosures to the shareholders are required. Once it is decided that disclosure will be made—*e.g.*, to obtain shareholder ratification—federal law governs the scope of disclosure. Liability under sections 10(b) and 17(a) for corporate transactions will, therefore, be largely reduced to the same sphere as liability under section 14(a) for proxy violations. The chief remaining nonsection 14(a) corporate mismanagement cases in which general antifraud liability would be recognized would be those involving misleading press releases²⁰⁴ and those involving misrepresentations to the board of directors.²⁰⁵

201. See Keeton, *Fraud—Concealment and Nondisclosure*, 15 TEXAS L. REV. 1, 11 (1936).

202. See Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 59-63 (1960); Walker, *The Duty of Disclosure by a Director Purchasing Stock from His Shareholders*, 32 YALE L.J. 637, 637-38 (1923).

203. See note 198 *supra*.

204. See the discussion of *Goldberg v. Meridor* at text accompanying notes 23-26 *supra*.

205. There may not be a cause of action, however, under the general antifraud provisions

C. *Extent of Liability for Misrepresentation*

(1) *Materiality.* As was noted in section IV.A.(3), federal liability for misrepresentation should not be so extensive as to deter disclosure in questionable situations or to create a federal cause of action when the real basis of liability is breach of a fiduciary duty. Both of these considerations are particularly applicable to the materiality standard. With respect to the second consideration, two courts have recently declared that courts should not subvert *Santa Fe* by permitting clever pleaders to convert what are essentially mismanagement claims into misrepresentation claims through the insertion into the case of inconsequential misrepresentations and non-disclosures.²⁰⁶ On the other hand, courts must avoid leaving shareholders inadequately protected by setting the materiality threshold too high. The problem of achieving the appropriate balance may be illustrated by some recent cases involving the same issues.

The first group of cases involves allegations by plaintiffs that the disclosure materials failed to characterize the transactions as unfair or harmful to the corporation,²⁰⁷ or failed to include computations that could have been made by the reader from figures that were disclosed.²⁰⁸ The courts have uniformly rejected these claims. A general rule in favor of liability in these cases could lead to liability whenever the transaction was unfair in the opinion of the court, and thus allow a nominal misrepresentation to create federal liability for substantive mismanagement.²⁰⁹

It would, however, be going too far to deny liability whenever the basic facts have been disclosed. Burying important facts in the middle of lengthy disclosure documents²¹⁰ or setting them forth in jargon too complicated for the average investor to understand should not be enough to avoid liability.²¹¹ Additionally, a claim that the defendant failed to dis-

for conduct expressly remediable under another provision of the securities laws. See note 144 *supra*.

206. *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d Cir. 1979); *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1366 (N.D. Tex. 1979).

207. *Selk v. St. Paul Ammonia Prod., Inc.*, 597 F.2d 635, 636 (8th Cir. 1979); *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349 (N.D. Tex. 1979); *Biesenbach v. Guenther*, 446 F. Supp. 98, 99 (E.D. Pa. 1978), *aff'd*, 588 F.2d 400 (3d Cir. 1979); *Helfant v. Louisiana & S. Life Ins. Co.*, 459 F. Supp. 720, 722-23 (E.D.N.Y. 1978); *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228, 1235 (D. Del. 1978); *Lavin v. Data Sys. Analysts, Inc.*, 443 F. Supp. 104, 105-06 (E.D. Pa. 1977); *Goldberger v. Baker*, 442 F. Supp. 659, 662 (S.D.N.Y. 1977).

208. *Nash v. Farmers New World Life Ins. Co.*, 570 F.2d 558, 561-62 (6th Cir. 1978); *Ash v. LFE Corp.*, 525 F.2d 215, 218 (3d Cir. 1975).

209. The SEC apparently did not find this consideration persuasive. In its "going private" rules, the SEC simply replaced rules setting forth substantive standards for going private transactions, which had been attacked as exceeding the Commission's authority, with rules requiring disclosure as to whether these same substantive standards were met. See rule 13e-3, 17 C.F.R. § 240.13e-3 (1979); *Going Private Transactions by Public Companies or Their Affiliates*, Securities Act Release No. 33-7000, Exchange Act Release No. 34-16075, Investment Company Act Release No. IC-10805 (1979), at 28-29; [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,166.

210. See *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 774 (3d Cir. 1976) (recognizing liability).

211. See generally *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 566 (E.D.N.Y. 1971) (discussing a duty under the 1933 Act to present information clearly); *In re*

close that the transaction was unfair could really be a claim that the substantial unfairness of the transaction did not appear from the facts disclosed by defendant, which would qualify as a material nondisclosure.²¹²

Another group of problem cases involves allegations of nondisclosure in proxy materials of minority shareholders' contentions or legal theories concerning the contested transaction. Courts have properly denied liability when the legal theories advanced were of such doubtful validity that the shareholders may have been in a worse position if the theories had been disclosed.²¹³ Conversely, it would be going much too far to say that an omission of a legal theory may *never* be material. The pertinent question is whether plaintiff's contentions are sufficiently undisputed that presentation of them would have been helpful to a voting shareholder.²¹⁴

Finally, some courts have held that failure to disclose the purpose of the transaction, such as the entrenchment of incumbent directors' control, was not a material omission.²¹⁵ When, however, the undisclosed purpose is itself harmful to the corporation, disclosure should be, and has been,²¹⁶ required. Also, disclosure of the purpose of the transaction may help shareholders evaluate the transaction by putting them on notice of any director self-interest in approving the transaction. Some courts have held the purpose of a transaction to be a material fact under these circumstances.²¹⁷

Universal Camera Corp., 19 S.E.C. 648 (1945); *Notice of Adoption of Amendments to Registration Guides to Improve Readability of Prospectuses*, Securities Act Release No. 5278, 1 FED. SEC. L. REP. (CCH) ¶ 3766 (1972).

212. See *Goldberg v. Meridor*, 567 F.2d 208, 218 n.8 (2d Cir. 1977). See also *Hundahl v. United Benefit Life Ins. Co.*, 965 F. Supp. 1349 (N.D. Tex. 1979), involving a claim which is very close to the materiality line. The court in that case resolved the materiality question by making what can only be called a "gut" decision that the case was so much like a mismanagement case that liability would violate the spirit of *Santa Fe*.

213. *Umbriac v. Kaiser Indus.*, 467 F. Supp. 548, 554 (D. Nev. 1979); *Voege v. Magnavox Co.*, 439 F. Supp. 935, 941-42 (D. Del. 1977); *Shapiro v. Belmont Indus.*, 438 F. Supp. 284, 292 (E.D. Pa. 1977); *Abramson v. Nytronics, Inc.*, 312 F. Supp. 519, 525-26 (S.D.N.Y. 1970).

214. For example, in *Voege v. Magnavox Co.*, 439 F. Supp. 935 (D. Del. 1977), the plaintiff alleged that a merger was falsely represented to be in accordance with a Delaware law that gave the shareholders the options only to surrender their shares or seek appraisal. The court declared that this was not a material misrepresentation because the nondisclosed fact was merely a contention about the law that differed from the defendant's position. If the plaintiff's arguments had been correct, failure to disclose them would have been material. *Id.* at 941-42.

215. *Rodman v. Grant Foundation*, 608 F.2d 64 (2d Cir. 1979); *Alabama Farm Bureau Mut. Cas. Ins. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979); *Gollub v. PPD Corp.*, 567 F.2d 759 (8th Cir. 1978); *Bucher v. Shumway*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,142 (S.D.N.Y. 1979); *Siegel v. Merrick*, 422 F. Supp. 1213 (S.D.N.Y. 1976).

216. *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d Cir. 1979).

217. *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083 (2d Cir. 1977); *Fuchs v. Swanton Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,133 (S.D.N.Y. 1979); *Weber v. Bartle*, 272 F. Supp. 201 (S.D.N.Y. 1967). A possible explanation for the different results in these cases from those cited in note 215 *supra* is the different views of the courts as to the obviousness to investors of the directors' purpose. In *Rodman v. Grant Foundation*, 608 F.2d 64 (2d Cir. 1979), the court's reason for denying liability for nondisclosure of the director's purpose was that directors always act to entrench their control.

(2) *Causation.* As was noted in section II.C., many different arguments have been advanced to sustain a cause of action when there was a question as to how a full disclosure would have affected the transaction. How should these arguments be dealt with under the scheme proposed here?

In the first place, all of the forms of causation discussed in section II.C. have greater validity when the basis of liability is, as proposed here, actual misrepresentation or face-to-face dealings, than when the case involves nothing more than nondisclosure of the mismanagement to shareholders. A misrepresentation or face-to-face nondisclosure is more likely to induce reliance than a simple failure to disclose to shareholders. Although there will still be a question as to whether the shareholders' or directors' course of action would have been fruitful, the increased certainty that the action would have been pursued tips the balance toward plaintiff.

Applying these considerations specifically to the state action-preclusion type of causation,²¹⁸ the federal courts should require only that the plaintiff would have been able to allege a *prima facie* state mismanagement case, and not that the plaintiff prove that such an action would have been successful in the state court. As noted above,²¹⁹ it is necessary to weigh the advantages of ensuring that the plaintiff's damage was caused by the misrepresentation, as opposed to any breach of a substantive duty, against the disadvantage of forcing the federal courts, in effect, to try a state action. Since the presence of an actual misrepresentation provides some assurance of reliance, and therefore causation, the advantage of the slightly greater certainty provided by a "success" test is outweighed by the logistical disadvantage of such a rule.

This leaves the problem of how to deal with a case in which there was no discernible action open to shareholders or directors to defeat the transaction. It can rarely be assumed that nothing can be done to stop a transaction, and, in all events, liability serves as an important deterrent. On the other hand, the shareholder's loss in this situation is arguably caused by the substantive mismanagement itself, rather than, as it should be to qualify for a section 10(b) remedy, on the lack of full disclosure.

One solution to this specific problem, as well as to other causation problems, would be to consider the various elements of the cause of action together in determining liability. Thus, when a transaction is submitted for approval to the shareholders and there is a majority of disinterested shareholders, or a minority with substantial appraisal rights, a low level of materiality might be sufficient for liability. When, however, there has been a misrepresentation of facts of undeniable significance to the ordinary investor, liability might be imposed even though the disinterested minority had no immediately discernible recourse, or the misrepresentation was not directly related to the mismanagement causing the loss. In the latter situation, it is more appropriate to speculate as to the availability of recourse

218. See text accompanying notes 85-89 *supra*.

219. See text accompanying note 88 *supra*.

since the effect on the shareholders is clear, and since the conduct so directly contravenes the securities laws.

(3) *The Director-Election Cases—The Proximity of Relationship.* When fraud is alleged in proxy materials concerning the election of directors and the election allegedly results in mismanagement by the directors elected thereby, the materiality and causation issues are even more complicated.²²⁰ The response of the courts in these cases has uniformly been to dismiss the complaint. The courts state in various ways that misrepresentations in proxy solicitations for director elections cannot furnish the basis of a cause of action for damages resulting from the director's acts because the proxy materials are necessarily too remote from the misdeed.

There are good reasons for denying liability in cases of this sort. In the first place, there is a factual causation problem: Assuming that the election was caused by the misrepresentation, can it be said that the transaction complained of would not have occurred under other directors? This is arguably not a serious problem if, as in all of the cases of this type decided to date, the nondisclosure is related to the injury. While different directors might have committed the same act, this would be unlikely if the shareholders had been alerted to, and expressed their displeasure with, the practice. There would, however, be no factual causation if the transaction for which the plaintiff seeks recovery is not related to the misrepresentation, since there is no particular reason why the transaction would not have occurred even if different directors had been elected.

There is also a materiality problem. Several of the cases involved directors who had been reelected after full disclosure of the mismanagement,²²¹ indicating very strongly that the nondisclosures were not material.²²² Although this circumstance did not exist in all cases, the cases have generally involved illegal foreign payments, and it may be supposed that the reac-

220. *Herman v. Beretta*, [1978-1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,574 (S.D.N.Y. 1978); *In re Tenneco Sec. Litigation*, 449 F. Supp. 528 (S.D. Tex. 1978); *Kammerman v. Pakco Cos.*, 75 F.R.D. 673 (S.D.N.Y. 1978); *Halle & Stieglitz, Filor, Ballard Inc. v. Empress Int'l Ltd.*, 442 F. Supp. 217 (D. Del. 1977); *Lewis v. Elam*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,013 (S.D.N.Y. 1977); *Limmer v. General Tel. & Elec. Corp.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,111 (S.D.N.Y. 1977); *Markewich v. Adikes*, 422 F. Supp. 1144 (E.D.N.Y. 1976); *Ketchum v. Green*, 415 F. Supp. 1367 (W.D. Pa. 1976); *Epic Enterprises, Inc. v. Brothers*, 395 F. Supp. 773 (N.D. Okla. 1975). These cases should be distinguished from those in which the plaintiff is seeking to enjoin the election itself rather than to obtain relief in connection with the subsequent mismanagement. As the courts noted in two such cases, *Weisberg v. Coastal States Gas Corp.*, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 97,168 (2d Cir. 1979), and *Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F. Supp. 787, 794 (S.D.N.Y. 1978), the directness of the relief sought serves to distinguish it from the cases discussed *supra*.

221. *Herman v. Beretta*, [1978-1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,574 (S.D.N.Y. 1978); *In re Tenneco Sec. Litigation*, 449 F. Supp. 528 (S.D. Tex. 1978); *Lewis v. Elam*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,013 (S.D.N.Y. 1977).

222. In *Herman v. Beretta*, [1978-1979 Transfer Binder] FED. SEC. L. REP. ¶ 96,574 (S.D.N.Y. 1978), relief was denied on the ground that the complaint was moot in view of the reelection of the directors. Since the suit, however, sought relief in connection with the illegal payments, rather than the election, the court mischaracterized the ground of decision.

tion of shareholders in the cases where there was reelection after disclosure was typical.

Even if the misstatements were material and there was sufficient factual causation, there is an additional problem of proximate or legal cause: The scope of liability ought, in fairness, to be adequately related to the grounds of liability. The defendants' defective disclosures were aimed at or risked only fraudulent elections, not the improper payments, and liability that goes beyond having the elections overturned is not properly related to the misleading disclosures.

Despite all of the above reasons for denying liability in this type of case, a rule denying liability in *all* such cases is too broad. A case could easily be imagined in which the shareholders, in voting on one matter, are in effect voting on the transaction that will lead eventually to the shareholder loss. An example would be an election explicitly involving the issue of whether the corporation "goes private," with the winning slate misrepresenting that it would oppose that course of action.²²³ In this situation, the harm has directly followed from the misrepresentation in the sense that the director election was itself a "referendum" on going private. There is probably factual causation, assuming the election resulted from the misrepresentation, since the directors were being elected on the basis of their positions regarding the precise transaction they later voted on, and proximate causation exists in the sense that the liability is related to the subject of the misrepresentation. Thus, there should be liability for the misrepresentation.

D. *The Role of the Securities Transaction*

The problems presented by the requirement that the fraud be "in connection with the purchase or sale of a security" were discussed in section II.D. The anomalous distinctions created by hinging federal liability to corporations for corporate transactions on the existence of a securities transaction coupled with the very loose judicial interpretations have left confusion about when liability in this context will or should be denied for want of a securities transaction.

A simple solution to these problems would be to impose federal liability to the corporation with respect to any corporate transaction caused by a breach of duty to disclose in the sense discussed in the preceding subsections.²²⁴ This would be consistent with the general purpose of the "in connection with" requirement to ensure that federal law governs only the type

223. In *Halle & Stieglitz, Filor, Ballard Inc. v. Express Int'l, Ltd.*, 442 F. Supp. 217 (D. Del. 1977), the plaintiff alleged nondisclosure of intent to go private. Under the analysis suggested here, the case would have been a stronger one for recovery if there had been misrepresentations concerning the intent to go private, and thus a "referendum" on the issue.

224. See the discussion of causation in section IV.C.(2) *supra*. The present discussion applies only to recovery by the corporation for corporate transactions. See text accompanying note 227 *infra*, regarding liability in other contexts, and section IV.G.(1) *infra*, regarding liability to individual shareholders with respect to corporate transactions.

of transaction that needs federal protection. In a mismanagement case, the federal connection is provided by the fact that the transaction involves the activities of a publicly held corporation, whose disclosures must be controlled by federal law in order fully to protect the investor and the integrity of the stock markets.²²⁵ Any undisclosed mismanagement, whether or not it involves a purchase or sale of a security, may adversely affect investors' faith in the market. In fact, it is precisely in order to effectuate protection of the investor that federal law already reaches many corporate activities through the continuous reporting and proxy provisions.²²⁶

Extending liability to corporate transactions not directly involving a purchase or sale of a security would also be consistent with the extrinsic policies relied on here. Given extensive federal regulation of misrepresentations and nondisclosures in connection with corporate transactions generally, federal liability for corporate transactions not directly involving a purchase or sale of securities would not create a risk of erroneous policy judgments or adversely affect predictability. Liability for corporate transactions should be distinguished, however, from liability without regard to connection with a securities transaction for misrepresentations and nondisclosures in other contexts. Since there is no developed federal regulation of ordinary deceit, extending the federal remedy into that area would create a risk of erroneous policy judgments and introduce unpredictability.²²⁷

This proposal to modify the *Blue Chip Stamps* purchase or sale requirement would not mean that the federal cause of action would be unlimited, as some have feared.²²⁸ Rather, the federal action will depend on the breach of a duty of adequate disclosure. It will thus be oriented toward an explicit federal goal, and not dependent on a fortuitous securities transaction. If the deception requirement is made definite, as suggested here, there is no need for a further limitation to ensure that the federal cause of action retains proper scope.

The proposed rule would be consistent with the holdings of most recent mismanagement cases. As discussed in section II.D. above, the courts have already significantly abrogated the purchase or sale requirement. Although some claims for relief have been denied on purchase or sale

225. See *Ruckle v. Roto Am. Corp.*, 339 F.2d 24, 28 (2d Cir. 1964); *Weitzen v. Kearns*, 271 F. Supp. 616, 622-23 (S.D.N.Y. 1967); *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 27-28 (S.D.N.Y. 1963); W. PAINTER, *supra* note 121, § 26.2; Bloomenthal, *supra* note 63, at 351-52; Cary, *supra* note 147, at 700 (arguing for additional legislation rather than coverage under § 10(b)); Fleischer, *supra* note 63, at 1174-75; Comment, *supra* note 11, at 1117-19.

226. See Bloomenthal, *supra* note 63, at 352.

227. One context in which federal liability would not be justified is the trustee-beneficiary situation. Federal law should not apply to misrepresentations of nondisclosures by a trustee to a beneficiary unless those misdeeds involve securities transactions. In *Klamberg v. Roth*, 473 F. Supp. 544 (S.D.N.Y. 1979), in which the issue was not discussed, the court denied liability because of the absence of deception. Arguably, if there had been deception, liability could have been based in that case on the fact that the misdeeds of the trustee involved securities. Unlike a corporate transaction case, it would be the securities transactions that provide the basis for federal jurisdiction, rather than the trustee's deception alone.

228. See *Herpich v. Wallace*, 430 F.2d 792, 805-07 (5th Cir. 1970); Kaplan, *supra* note 113, at 925-26.

grounds, in some of these cases it was not at all apparent that there was even any actionable fraud.²²⁹ In other cases the courts sustained liability under an alternative claim.²³⁰ Thus, the cases as a whole evidence a willingness by the courts to uphold liability under some theory or another whenever there has been the requisite deception, regardless of the presence of a purchase or sale.

The broad rule suggested above should be subject to two qualifications. The first is that, consistent with the policies underlying the holding of *Blue Chip Stamps*, liability should be imposed only when the corporate plaintiff has engaged in a completed transaction. The specific holding of *Blue Chip Stamps* that plaintiff must have been a purchaser or seller of securities was based on the need to protect the federal courts from the kind of flimsy claims that result, for example, when a nonbuying offeree asserts that his failure to purchase was caused by defective disclosures. Whether such a plaintiff would have actually purchased, and if so, in what amount, is pure speculation. But, as long as there has been a completed transaction, that policy will be satisfied.²³¹

The second qualification to the proposed rule is that the transactions must involve corporations that are sufficiently public so that the misrepresentation will probably affect the securities markets. If the securities markets are unaffected, some basis must be found for federal liability other than the mere fact that the transaction is "corporate."²³²

Although the proposed rule would be consistent with the general scope of the federal securities laws, extrinsic policy considerations, and the holdings of recent cases, it would not be strictly consistent with the language of the current statute, and it would certainly be contrary to the express remedies provisions of the Federal Securities Code.²³³ Until the law is changed, courts could continue to reach results consistent with the proposed rule by an expansive reading of the "in connection with" requirement. The optimum solution would be to replace that requirement with one that more adequately expresses the general policies underlying the securities laws.

E. *Injunction Cases*

Suits for injunctive relief to block the damaging corporate action have

229. *Simmons v. Wolfson*, 428 F.2d 455 (6th Cir. 1970); *Goodall v. Columbia Ventures, Inc.*, 374 F. Supp. 1324 (S.D.N.Y. 1974); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890 (D. Me. 1971).

230. *See Wolf v. Frank*, 477 F.2d 467 (5th Cir. 1973); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970).

231. *See Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1029-30 (6th Cir. 1979).

232. *See Dyer*, *supra* note 54, at 13-14; Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947 (1976); Sherrard, *supra* note 156, at 1420. The 1934 Act itself provides some basis for this distinction. Although § 10(b) is not drafted in terms limited to public corporations, the 1934 Act's continuous reporting provisions, which are part of the background in light of which § 10(b) must be interpreted, apply only to relatively public companies. 15 U.S.C. § 78g (1976) (Securities Exchange Act of 1934, § 12g).

233. *See* section II.D.(2) *supra*.

been permitted, notwithstanding the purchaser-seller requirement.²³⁴ Policies relied on in this Article point to differences other than the purchaser-seller requirement between injunction suits and suits seeking to unwind the transaction or actions for damages.

First, since the remedy sought in injunction cases is not a very extreme one, it will not be as significant in terms of ordering management conduct. Therefore, it is not as important from a predictability standpoint that a high level of materiality be required. Secondly, if the injunctive remedy is limited to requiring proper disclosure and does not extend to preventing the transaction altogether, it is not necessary to ensure that the remedy is based on the misrepresentation rather than on the breach of fiduciary duty inherent in the transaction. Since the remedy is intended only to inform the market with respect to the transaction, the misrepresentation is significant even if there was no way that the shareholders could have prevented the transaction.

F. *Directors' Refusal to Sue: Burks v. Lasker*

In *Burks v. Lasker*²³⁵ the Supreme Court held that a state rule permitting disinterested directors to bar a derivative suit was not necessarily inconsistent with the federal securities laws. The Court reversed the Second Circuit's reversal of a dismissal of the claim and remanded for a determination of whether the refusal to sue was binding under state law, and whether the state rule was inconsistent with federal law.

Burks presents a number of questions, all of which involve the general problem discussed in this Article of the extent to which the federal courts should defer decision of a corporate problem to state law. In the first place, is *Burks* correct in giving the directors any power to block federal suits? Giving the directors such power would compromise federal protection of investors, including protection against the precise type of misrepresentation that is the specific concern of federal law. On the other hand, limiting director discretion to block derivative suits would invade an area now regulated by state law.²³⁶ Secondly, it is uncertain whether the Supreme Court intended to give directors a right to block claims arising under statutes other than the Investment Company Act²³⁷ and the Investment Advisers Act,²³⁸ the two statutes involved in *Burks*. The Ninth Circuit, in *Lewis v. Anderson*,²³⁹ recently applied *Burks* to allow directors to

234. See *Rosenblatt v. Northwest Airlines, Inc.*, 435 F.2d 1121 (2d Cir. 1970); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967); *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349 (N.D. Tex. 1979); ALI FEDERAL SECURITIES CODE § 1603, Revised Comment 3(a)(iv) (Proposed Official Draft 1978).

235. 441 U.S. 471 (1979).

236. The Court recognized this problem in *Burks*: "[I]n this field congressional legislation is generally enacted against the background of existing state law; Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute." *Id.* at 478.

237. 15 U.S.C. § 80a (1976).

238. *Id.* § 80b.

239. [Current] FED. SEC. L. REP. (CCH) ¶ 97,153 (9th Cir. 1979).

block a derivative suit brought under rule 10b-5. Finally, if there is a right to block, is this right limited at all by federal law, or is it to be determined solely by state law? The majority opinion in *Burks* held that the state rule applies only when it is consistent with federal law, but did not provide any precise guidelines as to when such consistency exists.²⁴⁰ Justices Stewart and Powell, concurring, advocated applying state law without any further inquiry as to consistency.²⁴¹

The policy analysis presented in this Article provides a basis for evaluating the *Burks* holding, as well as answers to the questions posed by *Burks*. In short, state rules permitting directors to veto derivative suits should be given full effect in federal cases. The extent to which directors should be permitted to block federal derivative suits presents a complicated corporate governance problem of balancing the danger of preventing legitimate suits against the need to give the directors discretion to protect the corporation from litigation contrary to its best interests. Since this is a problem that has long been addressed by state courts,²⁴² considerations of deference to state policy judgments²⁴³ and predictability²⁴⁴ justify relying on state law. The countervailing need of a uniform public policy is insufficient to outweigh these considerations.²⁴⁵ There is, of course, a risk that such state rules may permit a blockage of many federal suits. This rule, however, presents no greater threat to the policy underlying federal law than the one proposed in this Article²⁴⁶ to leave to state law the determination of when disclosure is required. In both cases, the enforcement of federal policy must give way to the policies favoring deference to state law.

G. *The Corporate-Market Distinction*

As was discussed in section IV.A.(5), corporate transactions should be distinguished from market transactions. Since the latter are the focus of the securities laws and are traditionally regulated under federal rather than state law, they should be remediable under federal law even if they do not involve the actual misrepresentations or omissions discussed in section IV.B. The problem, however, is identifying "market" transactions.

240. 441 U.S. at 479-80. *Lewis v. Anderson*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,153 (9th Cir. 1979), held that there was consistency since neither rule 10b-5 nor the business judgment rule permitted liability for negligence, and since permitting dismissal of the suit by disinterested directors would not weaken the federal securities laws. This reasoning is questionable. If the test for consistency is whether permitting the directors to block will weaken the application of federal law, it is obvious that there will always be some inconsistency. On the other hand, the test for consistency with the general antifraud provisions cannot properly involve a comparison between the standards applied under state and federal law, as was attempted in *Lewis*, since the court would be comparing two completely different types of standards: those involving the degree of disclosure required, and those involving the degree of director discretion permitted.

241. 441 U.S. at 487.

242. See, e.g., *Findley v. Garrett*, 109 Cal. App. 2d 166, 240 P.2d 421 (1952); *Groel v. United Elec. Co.*, 70 N.J. Eq. 616, 61 A. 1061 (Ch. 1905).

243. See text accompanying notes 170-71 *supra*.

244. See text accompanying notes 172-79 *supra*.

245. See text accompanying notes 168-69 *supra*.

246. See sections IV.A.(2) and IV.B. *supra*.

The easiest type of case to characterize is one involving liabilities or rights of securities dealers, in which corporate duties cannot be said to be involved.²⁴⁷ The following cases are not so simple to categorize.

(1) *Deceiving Market re Mismanagement.* Market cases should be distinguished from cases in which liability is based upon a breach of duty owed to the corporation, but is asserted on behalf of investors who claim to have been injured by nondisclosures to the market concerning the transaction.²⁴⁸ Even though the injury has occurred in the market, the important fact governing applicability of federal or state law is whether defendant is engaged in the type of transaction with respect to which it is better to look for state law for guidance. Moreover, it is just as irrational to distinguish between investors who have retained shares and those who have traded them during the time of the fraud on "market-corporate" grounds as it is to do so on "in connection with" grounds.²⁴⁹ Those who have sold without disclosure may have suffered a unique injury in that they will be unable to share in the recovery of a derivative suit,²⁵⁰ but these investors would be better protected by expanding state law protection than by a federal remedy that runs counter to the policies discussed here.

When there has been a misrepresentation to the shareholders,²⁵¹ there is no general policy reason to deny liability. The problem becomes one of connecting the plaintiffs' securities transactions with an actionable misrepresentation, and ensuring that the market plaintiffs do not gain double recoveries both as a buyer or seller and as a shareholder beneficiary of a derivative suit.

Two specific kinds of misrepresentation cases deserve special attention. The first involves misrepresentations that are only marginally material. A distinction should be made between a simple failure to include in disclosure materials a warning about the general possibility that mismanagement will occur²⁵² and a misrepresentation that there will be no mismanagement of a specific kind.²⁵³ The former type of case involves no more than a risk about which the ordinary investor would be aware and would disregard, and so cannot be regarded as material. The latter kind of representation, on the other hand, is more likely to have induced reliance in the ordinary investor.

247. See cases cited at note 197 *supra*.

248. See *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969) (recognizing liability); *SEC v. Joseph Schlitz Brewing Co.*, 452 F. Supp. 824 (E.D. Wis. 1978) (SEC action based on injury to investors in market caused by nondisclosed mismanagement).

249. See discussion at notes 97-115 *supra*.

250. See, e.g., *Armstrong v. Frostie Co.*, 453 F.2d 914 (4th Cir. 1971).

251. See section IV.B. *supra*.

252. See *Lester v. Preco Indus.*, 282 F. Supp. 459 (S.D.N.Y. 1965) (denying liability); *Voege v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965) (recognizing liability in part on the theory of deception of plaintiff at the time of her original stock purchase).

253. See *Imperial Supply Co. Profit Sharing Trust v. Northern Ohio Bank*, 430 F. Supp. 339 (N.D. Ohio 1976); *Fox v. Prudent Resources Trust*, 382 F. Supp. 81 (E.D. Pa. 1974) (both recognizing liability).

The second type of problem case is that in which promoters are held liable to their corporation in connection with a scheme to defraud future shareholders.²⁵⁴ One theory of liability in such cases is that giving the remedy to the corporation is a device for compensating those who were brought into the corporation through misrepresentations.²⁵⁵ Even if there has been some disclosure to public investors of the promoters' illegal profits, the disclosure may not have been adequate to bring home to the investors the exact nature of the stock they are purchasing.²⁵⁶ If, in fact, there has been full disclosure to outside investors, and the real theory of liability is the promoters' breach of a substantive duty owed to the corporation, there should be no federal liability.²⁵⁷

(2) *Insider Trading.* There is ample basis for treating insider trading as a corporate transaction and for refusing to impose liability if the conduct consists of nothing more than a failure to disclose. Trading on the basis of inside information has been said to involve a breach of a fiduciary duty owed to the corporation,²⁵⁸ as well as to the stockholders with whom the insider trades.²⁵⁹ Therefore, taking advantage of inside position through trading on inside information resembles other forms of corporate mismanagement.²⁶⁰ Insider liability involves the recognition of a substantive duty to the corporation in connection with a transaction, a duty not to engage in the transaction or to disclose, just as in the corporate mismanagement situation. In fact, from the standpoint of ensuring a predictable result, insider trading arguably involves even more problems than other forms of mismanagement since it is especially difficult to determine what constitutes a forbidden insider trading transaction.

There are stronger arguments, though, for placing insider trading in the category of market transactions and for imposing liability even if the conduct may be characterized as breach of a substantive duty to disclose. In the first place, in an insider trading case there is an injury to investors that is separate from any to the corporation. For example, in a mismanagement case like *Britt v. Cyril Bath Co.*²⁶¹ both the corporation and trading investors were injured in the same way by nondisclosed insider self-deal-

254. *Miller v. San Sebastian Gold Mines, Inc.*, 540 F.2d 807 (5th Cir. 1976); *Bailes v. Colonial Press, Inc.*, 444 F.2d 1241 (5th Cir. 1971); *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963).

255. See Fleischer, *supra* note 63, at 1162.

256. See *Universal Camera Corp.*, 19 S.E.C. 648 (1945); *Notice of Adoption of Amendments to Registration Guides to Improve Readability of Prospectuses*, Securities Act Release No. 5278, 1 FED. SEC. L. REP. (CCH) ¶ 3766 (1972).

257. See *Miller v. San Sebastian Gold Mines, Inc.*, 540 F.2d 807, 810 (5th Cir. 1976) (indicating that complete disclosure to outside investors would preclude a cause of action).

258. *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

259. See *Strong v. Repide*, 213 U.S. 419 (1909).

260. For authorities analogizing insider trading and other mismanagement, see *Goldberg v. Meridor*, 567 F.2d 209, 221 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Ferraioli v. Cantor*, 281 F. Supp. 354, 358 (S.D.N.Y. 1968); *Cary*, *supra* note 147, at 700.

261. 417 F.2d 433 (6th Cir. 1969).

ing. By contrast, in *Speed v. Transamerica Corp.*²⁶² the Class A shareholders were specifically injured by the failure to disclose the increased value of the inventory.²⁶³ Moreover, it has been argued forcefully that the duty in an insider trading case should be based on broad considerations of fair dealing in the marketplace rather than simply on defendant's corporate position,²⁶⁴ and recent federal cases have moved away from the idea that federal insider trading liability depends on corporate position.²⁶⁵

The difference in character between insider trading and other mismanagement is reflected in the federal-state roles with respect to insider trading. The state cases recognizing liability to the corporation are exceptional, and common law liability to purchasers and sellers has been limited to cases involving face-to-face deception. In addition to the absence of state corporate law there is, of course, the recognized fact of substantial federal regulation in this area.

Insider trading is, therefore, predominantly a matter of federal market regulation rather than federal or state mismanagement liability, and federal courts should not have to defer substantive regulation to state law.

(3) *Duty to Disclose Apart from Mismanagement.* Just as insider trading qualifies for federal liability as a market transaction, so a corresponding duty should be imposed upon the nontrading corporation to disclose extraordinary events in order to protect against insider trading.²⁶⁶ Such a duty should be defined very carefully with a view to the significance of the information to the market and other circumstances relating to the fairness of imposing such an extraordinary duty.²⁶⁷ This duty to disclose should not become a back door through which liability to selected stockholders based upon substantive corporate mismanagement is brought.

V. CONCLUSION

The cases involving federal liability for corporate transactions under the

262. 235 F.2d 369 (3d Cir. 1956).

263. For a case similar to *Speed*, see *Green v. Hamilton Internat'l Corp.*, 437 F. Supp. 723 (S.D.N.Y. 1977).

264. See Brudney, *Insiders, Outsiders and Information Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322, 354-55 (1979); Fleischer, Mundheim, & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973).

265. See *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *cert. granted*, 47 U.S.L.W. 3740 (1979); *SEC v. Manderano*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,357 (D.N.J. 1978).

266. See *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.) (recognizing existence of such a duty, but denying liability under the circumstances of that case), *cert. denied*, 414 U.S. 874 (1973); Talesnick, *Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose?*, 49 DEN. L.J. 369 (1973). See also *Goldberg v. Meridor*, 567 F.2d 209, 221 n.10 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978), distinguishing this situation from a mismanagement case. But see *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 949 (2d Cir. 1969); and *Elkind v. Liggett & Myers, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,908 (S.D.N.Y. 1978), holding against a duty of disclosure.

267. See Talesnick, *supra* note 266.

general antifraud provisions pose many questions, few of which are answered either by *Santa Fe* or the proposed Federal Securities Code. An analysis of the statutes and extrinsic policy considerations provide a basis for the following scheme of liability:

(1) Liability for corporate transactions should be based only on misrepresentations or nondisclosures in disclosure materials distributed or released to shareholders or the market, or in face-to-face dealings with the decision-making body of the corporation.

(2) Materiality and causation standards with respect to corporate transaction cases should be devised to ensure that liability is, in fact, based on the kind of misrepresentations and nondisclosures described in (1) rather than on substantive mismanagement, but not so stringent as to deter disclosures to shareholders. These standards, however, should also be sufficiently high as to protect shareholders adequately. Moreover, materiality and causation standards may be relaxed in cases seeking preventative injunctive relief as opposed to those involving damages or an unwinding of the transaction.

(3) Liability for transactions by publicly held corporations should not depend on whether the specific transaction involves a purchase or sale of securities.

(4) With respect to transactions that are oriented primarily toward the market rather than the corporation, including broker-customer dealings and insider trading, liability may be imposed for conduct other than that described in (1) above. Market cases, however, do not include those in which there has been deception of the market in connection with corporate mismanagement.

The above scheme of liability is proposed as a guide to judges and practitioners who are working under the current law. All of these results may be reached consistently with the statutes as currently drafted. The result proposed in (3) above, however, may be reached only awkwardly under the current statute, and certainly not under the proposed Federal Securities Code. Since that result is much more consistent with the current scheme of federal liability than is that reached under a narrow view of the "in connection with" requirement, it is suggested that the Code be changed to accommodate this proposal.

The foregoing analysis is limited to liability under the current general antifraud provisions. Broader liability could be authorized, of course, under a broader statutory provision. Moreover, a more detailed statute or implementing regulation would not involve the policy problems emphasized in this Article. In the first place, rules that have been carefully worked out by a legislative or administrative body may more justifiably override established state rules than rules resulting from haphazard case-by-case adjudication. Secondly, there would be fewer problems of unpredictability and inconsistency if conduct were governed by a clear set of rules than there is under present case law.

An interesting question is whether the SEC may promulgate substantive

regulation of going private transactions under section 13(e) of the 1934 Act²⁶⁸ consistently with the analysis set forth in this Article. The Commission has gone no further than disclosure regulation,²⁶⁹ but has indicated that substantive regulation would be proper.²⁷⁰ The language and legislative history of section 13(e) may support the idea that it is directed at going private transactions,²⁷¹ just as the 1934 Act is aimed at market transactions, so that broader regulation of going private transactions is warranted than for other corporate mismanagement.²⁷² Perhaps, viewing the matter in the light of extrinsic policy considerations, there is just enough difference between section 13(e) and the other general antifraud provisions to warrant substantive regulation through rulemaking, but not through case-by-case adjudication. While SEC regulation would take the Commission into an area traditionally regulated by state law, and thus create a risk of erroneous policy judgments, the Commission's careful consideration and drafting of an integrated set of rules would prevent a strong predictability objection to the rules.

Whether federal legislation should be enacted that would effectively preempt corporate mismanagement issues is beyond the scope of this Article. Suffice it to say that careful thought should be given to whether the resulting benefits are worth the trouble involved. Federal mismanagement regulation would bring substantial new burdens to corporate managers and federal courts. Even if investors in public corporations are not sufficiently protected by state law, it is questionable whether the interests of this group, who take deliberate risks and whose losses are purely economic in nature, are sufficiently in need of protection to justify the new burdens additional federal legislation would bring. If it is claimed that the capital markets would be protected by such legislation, the presumption against a need for such protection is much greater now than it was in 1933.

268. 15 U.S.C. § 78m(e) (1976) (Securities Exchange Act of 1934, §13(e)). Section 78m(e)(1) provides in part:

It shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 78f of this title, or which is a closed-end investment company registered under the Investment Company Act of 1940, . . . to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices.

269. See note 209 *supra* for a discussion of the SEC going-private rules.

270. See *Going Private Transactions by Public Companies or Their Affiliates*, Securities Act Release No. 33-5884, Exchange Act Release No. 34,14185, Investment Company Act Release No. IC-10015, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366, at 88,742.

271. *Id.*

272. See text accompanying notes 194-97 *supra* for discussion of the corporate-market distinction.